ADMINISTRATION PROPOSAL TO RECAPITALIZE THE BANK INSURANCE SYSTEM, MODIFY THE REGULATION OF BANKS AND OTHER DEPOSITORY INSTITUTIONS, AND EXPAND ALLOWABLE ACTIVITIES OF BANKING CORPORATIONS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

MAY 29, 1991

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ADMINISTRATION PROPOSAL TO RECAPITALIZE THE BANK INSURANCE SYSTEM, MODIFY THE REGULATION OF BANKS AND OTHER DEPOSITORY INSTITUTIONS, AND EXPAND ALLOWABLE ACTIVITIES OF BANKING CORPORATIONS

WEDNESDAY, MAY 29, 1991

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
TUESDAY, MAY 14, 1991

PRESS RELEASE #9
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING TO REVIEW CERTAIN ASPECTS OF THE ADMINISTRATION PROPOSAL TO RECAPITALIZE THE BANK INSURANCE SYSTEM, MODIFY THE REGULATION OF BANKS AND OTHER DEPOSITORY INSTITUTIONS, AND EXPAND ALLOWABLE ACTIVITIES OF BANKING CORPORATIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced a hearing to review the tax and debt management aspects of the Administration proposal to recapitalize the bank insurance system, modify the regulation of banks and other depository institutions, and expand allowable activities of banking corporations. The Committee will receive oral testimony from invited witnesses representing the Administration and industry experts. The hearing will be held on Wednesday, May 29, 1991, beginning at 10:00 a.m. in the Committee's main hearing room, 1100 Longworth House Office Building.

In announcing this hearing, Chairman Rostenkowski stated: "The Administration has made a legislative request to provide the bank insurance system with additional funds to cover losses and working capital needs. In addition, the Administration proposal would expand the activities in which banking corporations can engage, and would significantly modify the regulation of the bank and savings and loan industry.

"The Committee on Ways and Means will review the tax and debt management aspects of the Administration proposal. In this regard, the Committee will review whether proposed expanded business activities for bank groups warrant reconsideration of tax laws governing banks and competing financial institutions. In addition, in furtherance of its jurisdiction over the Nation's bonded indebtedness, the Committee will consider whether the bank insurance fund refinancing proposals are the most cost-efficient means available for recapitalizing the bank insurance fund."

BACKGROUND:

On March 20, 1991, H.R. 1505, a bill to recapitalize the bank insurance system and to modify the regulation of the industry was introduced at the request of the Administration by Chairman Gonzalez and Mr. Wylie of the Committee on Banking, Finance and Urban Affairs. The bill would expand the ability of the Federal Deposit Insurance Corporation (FDIC) to borrow funds. The bill would also revise the regulatory structure of Federally-insured depository institutions, modify deposit insurance coverage, and expand the activities in which banking institutions may engage. In addition, the bill would expand the use of taxpayer identification numbers for registering insured deposits.

H.R. 1505 was jointly referred to the Committee on Ways and Means, the Committee on Banking, Finance and Urban Affairs and the Committee on Energy and Commerce. In addition, on April 25, 1991, Chairman Gonzalez introduced H.R. 2094, legislation providing for expanded FDIC borrowing from the Federal Government, and for other purposes. On May 7, 1991, the bill was forwarded, as amended, by the Subcommittee on Financial Institutions Supervision, Regulation and Insurance to the full Committee on Banking.

MORE

The Committee on Ways and Means anticipates receiving testimony to assist its consideration of the changes to the Internal Revenue Code of 1986 proposed by H.R. 1505, including provisions of the bill that would (1) allow certain tax-free transfers of funds, (2) require that all bank deposits include the taxpayer identification number of each depositor, and (3) make other proposed changes. The Committee will also consider testimony regarding the continued feasibility of current tax rules applicable to banks and other competing financial institutions in light of the proposed expanded business activities that would be permitted pursuant to the Administration proposal.

In addition, the Committee anticipates receiving testimony from invited witnesses that will provide information relating to the potential losses attributable to insolvent banks and the most effective means for funding those losses.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any interested person or organization may file written comments for inclusion in the printed record. Persons submitting written comments for the printed record of the hearings should submit at least six (6) copies by the close of business Thursday, June 6, 1991, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C., 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

* * * * *

Mr. GIBBONS. Today the committee will hear testimony on the administration's proposal to recapitalize the bank insurance system, modify the regulation of banks and the depository institutions, and expand allowable activities of banking corporations.

The committee will hear testimony from the administration on the most efficient way to recapitalize the Bank Insurance Fund.

Further, the committee will be very interested in the administration's opinion on whether the banking system has the necessary financial solvency to cover losses from troubled institutions or whether taxpayer assistance will ultimately be necessary.

The committee will also consider the tax aspect of the administration's proposal and will receive testimony on the Tax Code provisions that we may wish to review in the future in light of the proposed expanded activities that would be permitted for banking corporations pursuant to the administration's proposal.

The committee will also receive testimony on the administration's proposal to require all bank deposits include taxpayer identification numbers of each depositor.

The Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Banking Committee last week completed its consideration of the administration's proposal.

It is not clear to us now which parts of the administration's proposal will ultimately be endorsed by the full Committee on Banking.

This hearing would give the members of this committee an opportunity to consider these issues in the event we are asked to act upon the administration's reform proposals that are within this committee's jurisdiction.

Our first witness this morning will be the Honorable Kenneth W. Gideon, Assistant Secretary for Tax Policy. And Mr. Robert R. Glauber, Under Secretary for Finance of the Treasury Department.

We welcome you gentlemen to the committee.

Mr. Glauber, we will hear from you first.

STATEMENT OF HON. ROBERT R. GLAUBER, UNDER SECRETARY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. GLAUBER. Thank you.

With your permission, I will read a short version of my testimony and ask that the entire statement be put in the record.

Thank you for the opportunity to discuss the administration's proposal to recapitalize the Bank Insurance Fund, that is BIF.

Let me begin by putting our recapitalization proposal in the context of our overall bill. H.R. 1505 is the administration's approach to modernize our outdated banking laws to make our system stronger and safer. It is the legislative culmination of an 18-month study by the Treasury Department of the banking system as mandated by FIRREA. We believe this comprehensive approach to banking reform is the only way to resolve the underlying problems in the banking system. Merely recapitalizing BIF would only put off the day of reckoning and increase the exposure of the taxpayer.

As Secretary Brady has said, we need to fix the banking problem, not just fund it. The administration's projections are that the Bank Insurance Fund will decline substantially over the next 5 years, reaching a negative net worth of over $22 billion by the end of 1996; these projections are based on a computer model that applies historical failure and loss rates to banks according to their capital levels. In addition to the administration's projections, there are a number of other projections of BIF which reach widely disparate conclusions. This only proves what Chairman Seidman of the FDIC often says: there can be little certainty in projecting BIF losses, particularly more than 2 years out.

Attached to my testimony as exhibit A, you will find summarized the results of BIF projections made by the CBO, the FDIC and the administration as well as a description of the methodology used by the administration. I would point out that the plan included in our legislation is adequate to deal with each of these scenarios.

The administration's proposal would give the FDIC authority to borrow up to $25 billion from the Federal Reserve banks for use as loss funds. These borrowings would bear interest at Treasury rates.

The FDIC would be required to increase premiums and dedicate them; that is, to set them aside in amounts sufficient to ensure the payment of interest and principle on any such borrowings. Thus, the Federal Reserve would be assured of repayment.

The plan would modify the FDIC's current borrowing limitation in two ways in order to permit the FDIC to use the new Federal Reserve borrowing authority to pay for losses as intended.

First, the plan would exclude any borrowing from the Federal Reserve from the existing limitation on obligations. Without this provision the FDIC would not have access to the full amount of funds.

Second, the legislation would allow the FDIC to count the unused portion of its existing $5 billion line of credit for purposes of calculating compliance with the obligation limitation. Without this provision, the FDIC would be unable to use its existing authority to borrow for working capital purposes from the Federal Financing Bank.

The legislation would impose an aggregate ceiling on insurance premiums for BIF insurance institutions of 30 basis points. Since the new risk-based premium authority included in our legislation would allow the FDIC to vary premiums depending on the riskiness of the institution, the FDIC would retain the authority to assess individual institutions more than 30 basis points. The ceiling would apply in the aggregate on all BIF-insured institutions.

As you know, on May 23, 1991, the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Banking Committee, favorably reported H.R. 1505 to the full committee. Generally, we are pleased with the subcommittee's efforts, which represent a commitment to comprehensive reform which we believe is so vital to the long-term health and stability of the banking industry. There are, however, a number of areas in the bill which we believe need to be fixed, including title IV, which deals with the BIF recapitalization.

Rather than accepting the FDIC and administration proposal for borrowing from the Federal Reserve, the subcommittee increased the FDIC's line of credit with Treasury from $5 to $30 billion. We believe there are several reasons why this approach is inappropriate.

First, we believe the Federal Reserve is the most appropriate source of loans for BIF. Chairman Seidman indicated that recapitalizing BIF is a liquidity issue. Banks can and will pay for recapitalizing BIF over time from future assessments, but they do not have sufficient liquidity to make the entire payment up front. Providing liquidity to the banking system is the traditional role of the Federal Reserve. This is a banking industry problem. Banks have traditionally paid for and financed their own failure costs. Since banks own the stock of the Federal Reserve, it is appropriate for the Federal Reserve to play a role in financing the recapitalization.

Some have expressed concern that having the Federal Reserve lend to BIF would compromise the central bank's independence in conducting monetary policy. I believe such a concern stands the proper argument on its head. The Federal Reserve is responsible for monetary policy and providing for the health, stability, and liquidity of the banking system. These responsibilities are inextricably linked. The levels the Federal Reserve sets for the discount rate, the Federal funds rate and the supply of bank reserves all determine in important ways the health of the banking system and the overall economy which are important determinants of the banks' ability to repay any loan to BIF.

Congress looked to the Federal Reserve in 1933 when the FDIC was initially capitalized. What made sense when the fund was started makes sense today. BIF should look to the Federal Reserve for standby lending support.

The subcommittee also made changes to our proposal for amending the FDIC's current borrowing or obligation limitation. This new proposal would make the FDIC's obligation limitation similar to the limitation that applies to borrowing by the Resolution Trust Corporation. Specifically, such borrowing would have to be jointly collateralized by 90 percent of the value of assets acquired in resolutions, with the remaining 10 percent coming from the unused portion of the borrowing authority available to pay for losses.

As has been the case with the RTC, this limitation formula could constrain the FDIC from borrowing for working capital purposes before the additional $25 billion in loss funds has been spent. Nevertheless, the proposal appears workable.

Finally, the subcommittee removed the 30 basis point ceiling on BIF insurance premiums contained in our legislative proposal. For reasons I have given in my testimony, we believe this ceiling should be retained.

In conclusion, let me say the time has come to address the urgent problems facing the banking industry. We urge Congress to adopt the Financial Institutions' Safety and Consumer Choice Act of 1991.

Thank you, Mr. Chairman.

[The prepared statement follows:]

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

May 29, 1991

Chairman Rostenkowski, Representative Archer, and members of the Committee, thank you for the opportunity to discuss the Administration's proposal to recapitalize the Bank Insurance Fund (BIF).

Let me begin by putting our recapitalization proposal in the context of our overall bill. H.R. 1505 is the Administration's comprehensive approach to modernize our outdated banking laws to make our banking system stronger and safer. It is the legislative culmination of an 18-month study by the Treasury Department of the banking system, as mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. We believe this comprehensive approach to banking reform is the only way to truly resolve the underlying problems in the banking system -- merely recapitalizing BIF would only put off the day of reckoning and increase the exposure of the taxpayer. As Secretary Brady has said many times, we need to fix the banking problem, not just fund it.

We believe that comprehensive reform must accomplish the following fundamental objectives:

-- First, we must make deposit insurance safe for taxpayers and depositors. That means stronger supervision, better capitalized banks, and the return of deposit insurance to its original purpose of protecting average depositors.

-- Second, it is time to modernize archaic laws to let banks catch up with their customers to deliver products more efficiently to consumers across the country -- which translates into greater convenience, lower interest rates and transaction fees for consumers, and more bank capital.

-- Third, we need to restore the international competitive position of the segment of our banking system that competes with banks around the world. Our economy is twice the size of our nearest competitor's, and a world class economy requires a world class banking system.

-- Fourth, we need a better capitalized BIF.

Today, I would like to focus on this last point, specifically, the issues surrounding the recapitalization of the BIF and the FDIC's borrowing authority.

The Need for Recapitalization

As the Committee is well aware, the BIF is at its lowest level in history as a percentage of insured deposits, and is projected to decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer.

The Administration's projections are that the BIF will decline substantially over the next five years, reaching a negative net worth of over $22 billion by the end of 1996. These projections are based on a computer model that applies historical failure and loss rates to banks according to their capital levels. In addition to the Administration's projections, there are a number of other projections of BIF, which reach widely disparate conclusions. This only proves what Chairman Seidman of the FDIC often says -- there can be little certainty in projecting BIF losses, particularly more than two years out. Attached as Exhibit A to my testimony, you will find summarized the results of BIF projections made by the Congressional Budget Office, the FDIC, and the Administration, as well as a description of the methodology used by the Administration. I would point out that the plan included in our legislation is adequate to deal with each of the scenarios.

The Administration's Proposal

Prior to the announcement of a recapitalization proposal, the FDIC and the banking industry engaged in lengthy discussions over how best to recapitalize the BIF. As these discussions proceeded, we set out four objectives that we believe a BIF recapitalization plan should meet. These objectives are:

First, the plan should provide sufficient resources for the FDIC to do its job.

Second, the plan should be financed by the industry.

Third, the plan should be structured to avoid further impairing the health of the banking industry.

Fourth, the plan should rely on generally accepted accounting principles.

After the discussions with the industry, the FDIC circulated an outline of a recapitalization proposal. This proposal contained a range of funding options, including authority to borrow from, and to sell stock to, the Federal Reserve, the Treasury, the banking industry, and the public. After making changes to narrow the range of funding options, the FDIC proposal was incorporated into our legislation, and it now satisfies the four objectives I just described -- perhaps most importantly, the plan relies on industry funds.

The plan would give the FDIC authority to borrow up to $25 billion from the Federal Reserve banks, for use as loss funds. These borrowings would bear interest at Treasury rates. The FDIC would be required to increase premiums and dedicate them -- that is, to set them aside -- in amounts sufficient to assure the payment of interest and principal on any such borrowings. Thus, the Federal Reserve would be assured of repayment.

The plan would also modify the FDIC's current borrowing limitation in two ways, in order to permit the FDIC to use the new Federal Reserve borrowing authority to pay for losses, as intended. First, the plan would exclude any new borrowing from the Federal Reserve from the existing limitation on obligations. Without this provision, the FDIC would not have access to the full amount of funds. Second, the legislation would allow the FDIC to count the unused portion of its existing $5 billion line of credit for purposes of calculating compliance with the obligation limitation. Without this provision, the FDIC would be unable to continue to use its existing authority to borrow for working capital purposes from the Federal Financing Bank.

Finally, the legislation would impose an aggregate ceiling on insurance premiums for BIF-insured institutions of 30 basis points. Since the new risk-based premium authority included in our legislation would allow the FDIC to vary premiums depending on the riskiness of the institution, the FDIC would retain the authority to assess individual institutions more than 30 basis points. The ceiling would apply in the aggregate to all BIF-insured institutions.

The Committee will recall that the ceiling on premiums was lifted just last fall, as part of the Omnibus Budget Reconciliation Act of 1990. The reasons for reimposing the ceiling are two. First, there is widespread agreement among the bank regulators, including Chairman Seidman, that a cap on premiums is important to allow the industry to continue to attract capital. Moreover, it is the FDIC's view that raising premiums to more than 30 basis points could cause substantially more bank failures, and thus be counterproductive. Second, the old ceiling was lifted in order to permit the FDIC to craft a recapitalization plan. Having proposed such a plan, we join the FDIC in urging the Congress to reimpose a ceiling of 30 basis points.

Bill Passed by Financial Institutions Subcommittee

As you know, Mr. Chairman, on May 23, 1991, the Financial Institutions Subcommittee of the House Banking Committee favorably reported H.R. 1505 to the full Committee. We are generally pleased with the Subcommittee's efforts, which represent a commitment the comprehensive reform which we believe is so vital to the long-term health and stability of the banking industry. Of course, there are a number of areas in the bill which we believe need to be fixed, including Title IV, which deals with the BIF recapitalization.

Rather than accept the FDIC and Administration proposal for borrowing from the Federal Reserve, the Subcommittee increased the FDIC's line of credit with Treasury from $5 billion to $30 billion. We believe there are several reasons why this approach is inappropriate.

First, we believe that the Federal Reserve is the most appropriate source of loans for BIF. Chairman Seidman has indicated that recapitalizing BIF is a liquidity issue: the banks can and will pay to recapitalize BIF over time from future assessments, but they do not have sufficient liquidity to make the entire payment up front. Providing liquidity to the banking system is the traditional role of the Federal Reserve.

Second, this is a banking industry problem, and banks have traditionally paid for and financed their own failure costs. Since banks own the capital stock of the Federal Reserve, it is appropriate for the Federal Reserve to play a role in financing the recapitalization.

Some have expressed concern that having the Federal Reserve lend to BIF would compromise the central bank's independence in conducting monetary policy. I believe such a concern stands the proper argument on its head. The Federal Reserve is responsible for both monetary policy and for guarding the health, stability, and liquidity of the banking system. These responsibilities are inextricably linked. The levels the Federal Reserve sets for the discount rate, the federal funds rate, and the supply of bank reserves all determine in important ways the health of the banking system and the overall economy, which are important determinants of the banks' ability to repay any loan to BIF.

Congress looked to the Federal Reserve in 1933 when the FDIC was initially capitalized. What made sense when the fund was started makes sense today. BIF should look to the Federal Reserve for standby lending support.

The Subcommittee also made changes to our proposal for amending the FDIC's current borrowing or obligation limitation. This new proposal would make the FDIC's obligation limitation similar to the limitation that applies to borrowing by the Resolution Trust Corporation (RTC). Specifically, such borrowing would have to be jointly collateralized by 90 percent of the value of assets acquired in resolutions, with the remaining 10 percent coming from the unused portion of the borrowing authority available to pay for losses. As has been the case with the RTC, this limitation formula could constrain the FDIC from borrowing for working capital purposes well before the additional $25 billion in loss funds has been spent. Nevertheless, the proposal appears workable.

Finally, the Subcommittee removed the 30 basis point ceiling on BIF insurance premiums contained in our legislative proposal. For the reasons I have already given, we believe this ceiling should be retained.

Conclusion

The time has come to address the urgent problems facing the banking industry. We strongly urge Congress to adopt the "Financial Institutions Safety and Consumer Choice Act of 1991."

EXHIBIT A

COMPARISON OF BIF ESTIMATES

($ in billions)

	1991	1992	1993	1994	1995	1996
Fund Net Worth						
OMB	4.4	(2.2)	(9.1)	(15.5)	(19.3)	(22.2)
CBO	1.4	(2.8)	(2.6)	(1.0)	0.9	4.2
FDIC - base	3.9	2.4	n/a	n/a	n/a	n/a
FDIC - pessimistic	0.0	(5.8)	n/a	n/a	n/a	n/a
Assets of Failed Banks						
OMB	62.4	62.4	62.4	56.1	40.6	40.6
CBO\1	96.6	66.9	44.6	37.2	37.2	29.7
FDIC - base	65.0	30.0	n/a	n/a	n/a	n/a
FDIC - pessimistic	90.0	70.0	n/a	n/a	n/a	n/a
Losses on Failed Banks						
OMB	12.0	12.0	12.0	11.5	8.8	8.5
CBO	13.0	9.0	6.0	5.0	5.0	4.0
FDIC - base	10.0	6.5	n/a	n/a	n/a	n/a
FDIC - pessimistic	13.9	10.8	n/a	n/a	n/a	n/a
Net Outlays (excl. FFB interest)						
OMB	15.9	9.2	6.7	5.0	(1.3)	(1.5)
CBO	12.4	3.9	(2.7)	(3.9)	(4.0)	(5.7)
FDIC	n/a	n/a	n/a	n/a	n/a	n/a
Premium Assessments						
OMB	21.25	23	23	23	23	23
CBO	21.25	27	30	30	30	30
FDIC	19.5	19.5	19.5	19.5	19.5	19.5
Deposit Base Growth						
OMB	3.9%	6.6%	7.3%	7.0%	6.7%	6.5%
CBO	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
FDIC	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%

\1 *Estimate based upon data supplied in CBO testimony of January 29, 1991.*

METHODOLOGY FOR BIF ESTIMATES IN 1992 BUDGET

- Estimates in the President's budget were derived from actual call report data on commercial banks.
- A bank failure model adjusted the capital levels of individual banks by predicting loan loss rates and earnings through 1993.
- This model assumed a continuation of recent patterns, with the following exceptions (to simulate a moderate recession):
  - Nonperforming loan rates double (on average); and
  - Loss rates and time required to dispose of assets are greater than the FDIC's historical experience, reflecting weaker real estate markets.
- Banks were put into groups according to their size (large, medium, small, and savings banks) and capital ratio (i.e., banks with capital < 0%, 0-3%, 3-6%, > 6%).
- The failure rate for banks in each of these groups during 1987 to 1990 was applied.
- The timing of failures was smoothed out over the period between 1991 and mid-95. Failures assumed to decrease significantly thereafter (by over 40 percent).
- A loss rate was applied to each of the groups of failed banks; this loss rate averaged 20 percent.
- Using recent experience as a guide, assumptions were made regarding types of bank resolutions, marketable vs. illiquid assets, and the pace of asset sales to estimate the FDIC's working capital needs resulting from failures occurring between 1991 and 1996.
- Premium assessments were assumed to rise to 23 basis points in mid-1991, and remain at that level through 1996.
- All of these assumptions were then incorporated into the presentation that appears in the President's budget.

Mr. GIBBONS. Mr. Gideon.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GIDEON. I am pleased to have this opportunity to discuss the Federal income tax aspects of the administration's comprehensive banking reform proposal. Although the administration's banking proposal is far reaching in many respects, the tax provisions are minor and intended to facilitate other reforms proposed. There are three such reforms and provisions described in my testimony.

First, conversion of common trust funds into mutual funds. A common trust fund is an arrangement in which assets from separate trusts are pooled and managed by a bank in its capacity as a fiduciary of the funds. A mutual fund, by contrast, frequently is an investment vehicle for the general public. The proposed legislation would permit all or substantially all of the assets of a common trust fund to be transferred to a mutual fund, without gain or loss being recognized to the participants in the common trust fund, whether the transfer results from a merger, conversion, reorganization or similar type of transaction.

Although the law is not entirely clear on this point, this kind of transfer is probably taxable currently. Without the tax-free treatment provided by the proposed legislation, banks would be prevented from converting common trust funds into mutual funds by State laws that treat the triggering of an income tax on trust fund participants as a breach of the bans' fiduciary obligations.

Permitting transfers without tax consequences will enable banks or their holding companies to take advantage of economies of scale and will facilitate the offering of new investment products, especially by small- or medium-sized entities that otherwise might be prevented by high start-up costs from entering the mutual fund market.

Reorganizing common trust funds as mutual funds also will encourage functional regulation of these funds by the Securities and Exchange Commission.

The proposed legislation would require that deposits in insured depository institutions be registered under the Social Security number or employer identification number of the depositor. This provision is meant to assist the Federal Deposit Insurance Corporation—FDIC—in aggregating all deposits held by a person in an insured institution for purposes of applying the $100,000 per-person per-institution limitation on deposit insurance coverage.

The proposed legislation would require the FDIC to use the least costly method of resolving insured depository institutions. Under this approach, the FDIC is to provide assistance in a way that satisfies its obligations to insured depositors at the least cost to the affected deposit insurance fund. The proposed legislation would provide further that in making this determination the FDIC is to treat foregone Federal tax revenues as if they were revenues foregone by the affected deposit insurance fund.

This provision would help to safeguard Government funds by ensuring that strategies for assisting troubled financial institutions are based upon assessments of the real cost to the Government of providing the assistance. It would have no direct effect, however, on the taxation of the affected institutions.

For the convenience of the committee my written statement contains a summary of special tax rules currently applicable to depository institutions.

I will be pleased to answer questions at this time.

I would ask that my full statement be included in the hearing record.

Mr. GIBBONS. Without objection, so ordered.

[The prepared statement follows:]

For Release Upon Delivery
Expected at 10:00 AM
May 29, 1991

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to discuss the Federal income tax aspects of the Administration's comprehensive banking reform proposal, the Financial Institutions Safety and Consumer Choice Act of 1991. Although the Administration's banking proposal is far-reaching in many respects, the tax provisions are minor and intended to facilitate the other reforms proposed. There are three such tax provisions described below.

Conversion of common trust funds into mutual funds

A common trust fund is an arrangement in which assets from separate trusts are pooled and managed by a bank in its capacity as a fiduciary of the funds. A mutual fund, by contrast, frequently is an investment vehicle for the general public.

The proposed legislation would permit all or substantially all of the assets of a common trust fund to be transferred to a mutual fund without gain or loss being recognized to the participants in the common trust fund, whether the transfer results from a merger, conversion, reorganization or similar type of transaction. Although the law is not entirely clear on this point, this kind of transfer is probably taxable currently. Without the tax-free treatment provided by the proposed legislation, banks would be prevented from converting common trust funds into mutual funds by state laws that treat the triggering of an income tax on trust fund participants as a breach of the banks' fiduciary obligations. Permitting transfers without tax consequence will enable banks or their holding companies to take advantage of economies of scale and will facilitate the offering of new investment products, especially by small or medium-sized entities that otherwise might be prevented by high start-up costs from entering the mutual fund market. Reorganizing common trust funds as mutual funds also will encourage functional regulation of these funds by the Securities and Exchange Commission.

Furnishing of taxpayer identification numbers

The proposed legislation would require that deposits in insured depository institutions be registered under the social security number or employer identification number of the depositor. This provision is meant to assist the Federal Deposit Insurance Corporation (FDIC) in aggregating all deposits held by a person in an insured institution for purposes of applying the $100,000 per-person-per-institution limitation on deposit insurance coverage.

Least-cost method of resolving insured institutions

The proposed legislation would require the FDIC to use the least costly method of resolving insured depository institutions. Under this approach, the FDIC is to provide assistance in a way that satisfies its obligations to insured depositors at the least cost to the affected deposit insurance fund. The proposed legislation would provide further that in making this determination the FDIC is to treat foregone Federal tax revenues as if they were revenues foregone by the affected deposit insurance fund. This provision would help to safeguard Government funds by ensuring that strategies for assisting troubled financial institutions are based upon assessments of the real cost to the Government of providing the assistance. It would have no direct effect, however, on the taxation of the affected institutions.

For the convenience of the Committee my written statement contains a summary of special tax rules currently applicable to depository institutions. I will be pleased to answer questions at this time.

Appendix

Summary of Special Tax Rules Applicable to Depository Institutions

Under current law, a limited number of special tax rules apply to depository institutions, including rules permitting certain depository institutions to use the reserve method of accounting for bad debts, presumptions regarding the worthlessness of loans, special rules governing the carryover of depository institution net operating losses, rules characterizing as ordinary income or loss the gain or loss incurred by a depository institution on any evidence of indebtedness, rules deferring the recognition of gain or loss by certain thrift institutions on foreclosure, and a tax exemption for credit unions.

Bad debt reserves

Generally, taxpayers may deduct bad debts only when the debts become partially or wholly worthless. However, certain commercial banks and thrift institutions are allowed to create a bad debt reserve and deduct an addition to that reserve each year. Under section 585 of the Code, commercial banks are allowed to deduct an addition to their reserve for bad debts based on their actual loan loss experience over the most recent 6 year period. The reserve method of section 585, however, may not be used by any large bank. In general, a bank is large for this purpose if, for the current or any preceding taxable year after 1986, (1) the average total adjusted bases of the bank's assets exceeded $500 million or (2) the bank was a member of a controlled group of corporations and the average total adjusted bases of the group's assets exceeded $500 million.

Under section 593 of the Code, qualifying thrift institutions generally are allowed (1) to deduct an addition to their reserve for losses on qualifying real property loans under the experience method or in an amount equal to 8 percent of their taxable income for the year and (2) to deduct an addition to their reserve for losses on nonqualifying loans using the experience method. In general, a thrift qualifies for the reserve method of section 593 only if at least 60 percent of its total assets consist of assets described in section 7701(a)(19)(C). This limitation is designed to concentrate the investments of qualifying thrifts in residential real property. A thrift that does not qualify under section 593 is generally entitled to use the section 585 reserve method unless it is large.

Bad debt deductions

All taxpayers who are denied the reserve method must use the specific charge-off method for determining their worthless debts for the taxable year, which requires a showing by the taxpayer that a debt became worthless and is properly deductible in the year in which the bad debt deduction is claimed. Since 1959, however, regulations have provided that banks and thrifts enjoy a conclusive presumption that a debt that is charged off for regulatory purposes is a worthless debt for tax purposes. A debt is treated as charged off for regulatory purposes only if it is charged off in obedience to a specific order of the regulator or, in the absence of a specific order, it is charged off in accordance with established regulatory policies and supported by a written confirmation by the regulator that the debt would have been subject to a specific order if an examination had been made on the date of the charge-off.

Practical difficulties can accompany the requirement that banks obtain written confirmation of worthlessness from regulators for each debt charged off during the taxable year. In response to this problem, the Internal Revenue Service is proposing an amendment to its regulations that would make available a "conformity election." This election would provide a conclusive presumption of worthlessness for tax purposes if a debt is classified by the bank as a loss asset under the applicable regulatory standards. To assure the continued supervisory oversight of charge-off policies, this conclusive presumption would be available only if the bank's supervisory authority has expressly determined that the bank maintains and applies internal loan classification and review standards that are consistent with the applicable regulatory standards.

The conformity of tax and regulatory treatment reflected in the current and proposed regulations extends only to the charge-off of bad debts. Whether conformity principles should be applied to other related tax issues, such as the accrual of interest on nonperforming loans that have been put into nonaccrual status for regulatory purposes, or adapted to the loan charge-off policies of unregulated financial institutions are issues that will be addressed by a Treasury Department study now in progress.

Net operating losses

Under section 172 of the Code, taxpayers are entitled to claim a deduction for net operating loss carrybacks or carryovers to a taxable year. Generally, taxpayers may carry a net operating loss back three taxable years and forward 15 taxable years. In the case of a depository institution using the specific charge-off method of accounting, the portion of any net operating loss for the taxable year that is attributable to the bad debt deductions of the institution is treated as a net operating loss carryback to the 10 preceding taxable years and as a net operating loss carryover to the 5 following taxable years. This special rule, however, only applies to net operating losses incurred for taxable years beginning after December 31, 1986 and before January 1, 1994.

Ordinary income treatment

Under section 582 of the Code, gain or loss incurred by a depository institution on an evidence of indebtedness is generally treated as ordinary income or loss.

Foreclosure gain or loss

Under section 595 of the Code, in the case of any thrift institution that qualifies for the reserve method of section 593, no gain or loss is recognized, and no debt is considered as becoming worthless, as a result of the institution bidding in at foreclosure, or otherwise reducing to ownership, any property that was security for an indebtedness.

Credit unions

Credit unions are exempt from tax on all income, whether retained or distributed to depositors. Tax is imposed on customer/owners only when income is distributed to them. As a result, if income is retained at the institution level, shareholders are able to defer tax on the undistributed income, and the income realized on the retained earnings is not subject to tax at the institution level.

Mr. **Gibbons**. Mr. Glauber, does your bill as reported from the subcommittee allow banks to enter the insurance field and the real estate field?

Mr. **Glauber**. It doesn't allow them to do it directly. It allows them to affiliate with insurance companies that would underwrite insurance where both the bank and the insurance company would be a subsidiary of the holding company.

There are, of course, firewall provisions which——

Mr. **Gibbons**. How about the real estate business?

Mr. **Glauber**. The answer to that is "no," it doesn't let banks invest in real estate directly. Again, it would be possible for a holding company, a so-called diversified company to own a business that was in the real estate business.

Mr. **Gibbons**. That seems to be a provision. The bank directors appointed themselves to another committee or another subsidiary. They pretend to run that out of a different pocket, under different rules and regulations, but they still have the economic decisions; don't they?

Mr. **Glauber**. There is one very important prohibition or firewall. That is the bank cannot lend to the real estate subsidiary. It cannot lend at all.

Mr. **Gibbons**. But it can lend to the customers of the real estate subsidiary.

Mr. **Glauber**. It can lend today to people who are in the real estate business.

Mr. **Gibbons**. I am opposed to that. You convince me that I am wrong.

Mr. **Glauber**. Well, I would start out by pointing out to you that banks make real estate loans today.

Mr. **Gibbons**. Unfortunately, they do. That is one of their big problems: they made way too many of them.

Mr. **Glauber**. On the other hand, if banks don't make real estate loans, it would be hard to build real estate, which is important to this country. I think done properly, real estate loans are an appropriate part of what banks do. Obviously, there are bad loans, and they can lend too much. But I think it is an appropriate activity.

I do think there could be conflicts of interest if the bank were allowed to lend to the real estate affiliate. We prohibit that. Furthermore, we prohibit in the bill any direct equity investment by a bank in real estate, which is permitted in some States today. We have gone a good distance, we think, in trying to cut back on real estate activities by banks sharing your concern for that kind of activity.

Mr. **Gibbons**. I have watched the real estate business for all 71 years of my life. It has to be the most highly speculative business that I know of. I think you ought to build more than a firewall between commercial banks and real estate. I think you ought to keep them out of it. We did well during the 1940s, and at all except on very temporary construction loan basis, and that was all, there was an outstanding commitment to purchase the financing when the building was completed.

Mr. **Glauber**. Again, I have a great deal of enthusiasm for what you are suggesting, that direct investment by banks in real estate is a mistake. We, indeed, in our bill rule that out. We say even if a

State authorizes a bank to invest directly in real estate we would not permit that. We would override State law. We override State law very seldom and carefully.

Mr. **Gibbons**. All you do is set up a subsidiary, a ghost over here of the bank, and then let them participate.

Mr. **Glauber**. If the subsidiary wanted to participate in the real estate business, it would have to raise its money from the market. The banks could not lend to the subsidiary that is in the real estate business, period.

Mr. **Gibbons**. But it could lend to the customers of the real estate business.

Mr. **Glauber**. That is perfectly true.

Mr. **Gibbons**. What is the difference?

Mr. **Glauber**. It would have to lend to the customers on the same basis as it lends to customers of any other company or to any customer.

Mr. **Gibbons**. What is the point of putting banks in the real estate business, as you are doing?

Mr. **Glauber**. I think we are going to great lengths to keep banks out of the real estate business in that sense.

Mr. **Gibbons**. I may be thick, but it seems to me you are talking out of both sides of your mouth on that one. I don't follow your argument at all, I must say, Mr. Glauber. I am opposed to putting banks anymore in the real estate business. It has been a disaster for all of my life. I watched the banks go down in 1929. I watched the banks go down in 1989. Both times it was the real estate business that pulled them into it.

Mr. **Glauber**. I understand your point. I just would like to emphasize that if anything, we take banks out of the real estate business. We deny them the right to invest directly in real estate. We do not allow them to make loans to an affiliate that would be in the real estate business. I think, in fact, we have taken them out of the real estate business rather than put them in.

Mr. **Gibbons**. Why let them set up a subsidiary that can carry on that activity?

Mr. **Glauber**. The question is this. Do you want to allow broad-based companies that have interest in real estate also to be in financial services?

The argument we make is that this would be an advantage to the economy and to customers. If we are going to allow broad-based, diversified companies to be both in other businesses, including real estate, but also on the banking industry, then we have to allow this. We think there are tremendous virtues to that. For one thing, companies that are in other kinds of businesses have a great deal of capital. Our banking system needs capital. We think this is a way of getting capital into the banking system. We think we can do it in a way that is safe.

Mr. **Gibbons**. I don't know why they need any more capital when they have all the depositors' money and get it almost for free; I can't understand it.

Mr. **Glauber**. The banks do get depositors' money. As you know, that isn't capital. That is loan money they have to pay back to the depositors. We are talking now about actual at-risk investment of the owners of the banks, and that isn't very large.

Mr. Gibbons. I wouldn't object to you increasing the requirement from about 6 percent now to whatever it would take to make those banks safe. The business that everybody in my community wants to get into is the banking business. I have been in it myself. I know it is a lucrative business.

Mr. Glauber. It also can be a business fraught with losses. What we do is give banks incentives to hold more capital. One of the keystones of our proposal is to give banks a reason to hold more capital. If we are going to do that, the question is where are they going to get it from? One place to get it is from companies that are not in the banking business, diversified companies, nonfinancial companies.

Mr. Gibbons. Convince me as to why I am wrong in keeping banks out of the insurance business?

Mr. Glauber. Again, what I would tell you is that banking and insurance are related financial activities. If we can find a way to do it safely and soundly, why would we want to prohibit a company that is in the insurance business, that wants to go into the banking business and that brings capital to the banking business from doing so? Why would we prohibit that as long as we can do it safely and soundly?

Mr. Gibbons. It is very anticompetitive. I walk into a bank and I am negotiating a loan, they want to try to sell me a little insurance?

Mr. Glauber. Clearly we have to tell them they cannot do that, and our bill says that.

Mr. Gibbons. They will kind of wink at you and say—you know. We don't really insist or require you to buy insurance, but you have a shaky loan here, Mr. Gibbons. How are you going to stop that?

Mr. Glauber. First, it is illegal. Second, in a number of States banks are able to sell insurance. It happens to be true of the State from which I come, Massachusetts. Savings banks' life insurance is really one of the great buys of insurance in my State.

Mr. Gibbons. Savings bank life insurance?

Mr. Glauber. Yes. You can buy insurance in a bank. It turns out, by my experience, to be a very good product, and consumers have greatly benefited from it. I don't think there have been what would be considered serious abuses of it. This is Massachusetts. I think it can be done in a way that serves consumers and avoids the kind of potential pitfalls that you raise.

Mr. Gibbons. You still have to convince me. You are going to have to look hard for my vote on that bill, I will tell you, as long as those two items are in there.

Mr. Glauber. With your permission, I would like to take another shot at it.

Mr. Gibbons. OK.

Mr. Gideon, why do we need to use a Social Security number on everybody's deposit?

Mr. Gideon. We think this would facilitate identification and enforcement of the $100,000 limit.

I might add that this is a fairly minimal additional burden since these numbers are already collected with regard to interest-bearing accounts by banks. Really, the only additional area of coverage that is imposed here is on things that would not be interest bearing, of which there are still some. But I think those are not the major form of bank checking even at this point in time.

Mr. GIBBONS. Mr. Pickle.

Mr. PICKLE. Gentlemen, thank you for your testimony.

Let me get back to the subject now about the BIF problem and your recommendations. Secretary Glauber, let me get some information just for the record here.

I realize that this is primarily a question under the jurisdiction of the Banking Committee. I know they are considering banking reforms, at least through the subcommittee and the full committee, so this committee is not trying to reach out and involve ourself in those committees' jurisdictions. At some point it will come to us. We are just trying to get some information now.

So let me ask you: You have asked for $70 billion now. The Banking Committee at one time just asked for $30 billion. Why do you need the extra amount? Is the full $70 billion needed?

Mr. GLAUBER. We didn't ask for $70 billion. What we asked for was an additional $25 billion to fill as needed the losses of the fund. What we said is there should be a facility for working capital, that is, to buy temporarily assets during resolutions, which could be as large as $45 billion. What the committee voted was an additional amount of loss funds of $25 billion, as we requested, and a facility for working capital, which could accommodate the needs of the FDIC for buying material assets in resolutions.

Mr. PICKLE. First, when do you think you will need this money so that you would have no delay in meeting the problem of failed banks?

Mr. GLAUBER. Chairman Seidman has said under his current forecast, the money will not be needed before the end of this fiscal year and probably some time well into the fourth calendar quarter.

Mr. PICKLE. Probably by the end of this fiscal year?

Mr. GLAUBER. Not before the end of the fiscal year. He said it will probably be needed in the last calendar quarter of this year.

Mr. PICKLE. Assuming it is by the end of this year, how much would you need in 1992?

Mr. GLAUBER. That, of course, depends on which forecast you look at and ultimately how in fact it turns out. I attached to my testimony various forecasts of various agencies. If you look at it, what you will see is that by the OMB forecast, the CBO forecast and the FDIC forecast, no money is needed in fiscal year 1991. Depending on what forecast you use in fiscal year 1992, either no money would be needed or as much as $4.5 billion might be needed.

Mr. PICKLE. $4.5 billion?

Mr. GLAUBER. By the most pessimistic forecast of the FDIC. That depends on assumptions. It depends on the outcome of the economy.

As you can see by the various forecasts that are made, they range all over the place. It is a highly uncertain business, trying to forecast the size of losses.

Mr. PICKLE. I understand. You are saying in 1991 we probably won't need any. In 1992, you might need up to $4.5 billion; what about 1993?

Mr. **Glauber**. In my testimony there are forecasts from CBO and OMB. FDIC has not made forecasts that go out beyond fiscal year 1992. CBO's forecast for fiscal year 1993 is $2.5 billion, roughly. OMB's is about $9 billion.

Mr. **Pickle**. I am not trying to hold you to a specific amount, but the general figure. I want to get into some statements of the Secretary, but let me flip over to the working capital.

Your bill, H.R. 1505, is secured by the assets acquired by the FDIC in the course of resolved bank failures; what assurance is there that the proceeds from the sale of the assets would be sufficient to pay these borrowings?

Mr. **Glauber**. There is no assurance. That is why under our bill, and indeed, under what the subcommittee voted out, in both cases the assets act as only partial security. The loan is overcollateralized. The assets are used as collateral only to 90 percent of their value. There has to be additional value from 10 percent posted from some other source. In that sense, it is very much the way the RTC operates, Mr. Pickle

Mr. **Pickle**. You indicate to me, then, that you need a lot of money for working capital, but working capital really represents only a small part of funds necessary.

Mr. **Glauber**. That really depends upon, again, what happens to people's forecasts. Working capital could be a number that is quite low. Indeed, if the FDIC has to make large resolutions, the working capital could rise in the range of $20 billion. Again, it depends on how quickly they can sell the assets, how many assets they have to take in in resolutions.

Mr. **Pickle**. How much money are you asking for working capital?

Mr. **Glauber**. No specific amount. There is a formula in our bill and in the subcommittee bill as voted out which limits working capital to an amount which is related to the unspent funds provided for losses.

Mr. **Pickle**. When we had this question of working capital before our committee, the savings and loan problem, the working capital was an enormous amount of money. You told this committee that it was really cash. It was a borrowing, but we are going to take this money, we sell this property and get a return on our borrowing. Therefore, it is not really an obligation. They are assets that we sell and, in effect, turn into cash.

That has not happened in this savings and loan mess. We are trying to sell this property. You are giving it away for free in my part of the country and other places. You are almost asking the public to buy it and you are not getting money from it.

Isn't the same thing going to happen with respect to the banks?

Mr. **Glauber**. That depends on what happens to the economy. The choice in selling assets is always a choice between holding them and trying to get a better price or dumping them on the market immediately and getting a worse price. That is a decision that the people doing the resolutions have to make.

Mr. **Pickle**. I do not leave the implication that the RTC has done a poor job and they have floundered around. The fact of the matter is they have not been able to sell these assets. It is a difficult, complex problem.

The same thing is going to be true with respect to the banks. You are telling me that is not a problem because working capital, the assets have held value, are really not a problem. You still have the same formula.

You can borrow up to 85 percent against the assets?

Mr. **Glauber**. The formula for the FDIC in the banking legislation is similar to the RTC. It allows the BIF to borrow up to 90 percent of the assets, but it is effectively the same formula.

Mr. **Pickle**. You have not satisfied me on what is going to happen if we do not get these moneys from these assets.

Mr. **Glauber**. The answer is the same for the FDIC and the RTC. To the extent these assets could not be sold, it would increase the amount of losses in the resolution.

Mr. **Pickle**. That means the taxpayers have to pay.

Mr. **Glauber**. Not in the case of the banking proposal. We propose a facility of up to $25 billion to be paid for by the banks, not the taxpayer. I would like to emphasize that if I could, Mr. Pickle.

Mr. **Gibbons**. Mr. Downey.

Mr. **Downey**. Thank you, Mr. Chairman.

Mr. Glauber, Mr. Gideon, welcome. Mr. John F. Bovenzi, the Deputy to the Chairman of the Federal Deposit Insurance Corporation says on page 9 of this testimony something I would like you to respond to. He says the FDIC transactions with financial affiliates can be just as abusive as those with commercial affiliates and that different types of firewalls based on the identity of nonbank affiliates are improper.

The question of what constitutes proper firewalls should not be confused with the issues related to bank ownership. Instead, he says, the adequacy and the appropriateness of each firewall should be determined on its own merits. The same firewall should apply to transactions between insured banks and their nonbank affiliates.

How would you respond to that?

Mr. **Glauber**. I think designing firewalls is a complicated issue. We do in fact have differentiated firewalls, if you will. We say that banks should be allowed to lend to their financial affiliates, a securities firm, for example, under certain prohibitions, such as a requirement of full collateralization and arm's-length transactions. It should not be allowed to lend at all to its nonfinancial affiliates. When I was talking to Mr. Gibbons, I pointed out there can be no lending at all for a real estate affiliate. There are different firewalls. We think that is proper.

Mr. **Downey**. Thank you, Mr. Chairman.

Mr. **Gibbons**. Mr. Cardin.

Mr. **Cardin**. Mr. Glauber, I would like to talk about the relationship between what would be borrowed either from the Federal Reserve or from the Treasury and the working capital as it relates to the debt ceiling of the Nation and the requirements last year in the Budget Act as far as pay-as-you-go.

It is my understanding, whether it be the administration's bill or the committee's recommendation, the borrowing would still be backed by the full faith and credit of the U.S. Government?

Mr. **Glauber**. Any borrowing by the FDIC is full faith and credit borrowing.

Mr. **Cardin**. How does the borrowing affect the debt ceiling?

Mr. GLAUBER. The borrowing in both cases is on budget, but exempt from pay-go whether it comes from the Fed or from the Treasury. Being on budget, I assume it would be counted against the debt ceiling to the extent it was borrowed.

Mr. CARDIN. Is this working capital also that would be subject to the debt ceiling?

Mr. GLAUBER. Borrowing for working capital would be subject to the debt ceiling as well.

Mr. CARDIN. By the enactment of this legislation we could be authorizing another $70 billion of additional potential borrowing against the debt ceiling?

Mr. GLAUBER. In principle. It depends obviously on what happens with resolutions and losses.

Mr. CARDIN. As far as being exempt from pay-go, that was a deliberate provision in the administration's bill?

Mr. GLAUBER. It is not in the administration's bill. It was in OBRA last year. It was explicitly in OBRA that transactions and resolutions under existing law by the FDIC would not be part of pay-go.

Mr. CARDIN. That was a decision made last year. The additional borrowing, as has been pointed out by the previous members of this committee, could be losses to the Federal Treasury, would be exempt from pay-go?

Mr. GLAUBER. They could be. Under our bill it is envisioned they would be repaid by the industry. It would be our expectation they would be.

Mr. CARDIN. Does it concern you that we give this additional authority to potentially increase the amount of debt outstanding to the banking system?

Mr. GLAUBER. I think you should see it in context. The nature of this plan, both as regards loss funds and working capital, is that the money would be repaid. In the case of working capital, it would be repaid by the sale of assets. In the case of loss funds, it would be repaid by premiums of the banking industry. In both cases, it is not a permanent expenditure of funds, and the money would reflow.

If it were part of pay-go, you would have this odd situation of money flowing out and then a receipt coming back later, which would in fact be money to be spent under pay-go. I think it makes sense that it not be part of pay-go.

Mr. CARDIN. Mr. Gideon, I understand the tax provisions are relatively minor in the bill. I am having a difficult time understanding what makes a common trust fund so special that it should have special treatment in regard to mutual funds. I take it there is a cost factor involved.

Mr. GIDEON. Common trust funds have arisen as a way of banks pooling the assets of their small trusts so they can invest on a common basis. The provision in this bill would encourage conversion of those funds into mutual funds by simply saying that converting a common trust fund into a mutual fund would be a tax-free transaction.

Mr. CARDIN. Why would that be different than an individual trust which might have individual assets that make more sense to convert into mutual funds also? Why shouldn't we permit the smaller trust that may not be administered by a bank to be able to be transferred into mutual funds without recognizing the gain?

Mr. **Gideon**. There is an issue of diversification. Presumably most bank common trust funds already meet the diversification rules.

Mr. **Cardin**. If I am an independent trustee, not a bank, I have certain fiduciary responsibilities also to diversify. I could be in the same type of a situation, but just not a bank. Why should a bank trust be favored?

Mr. **Gideon**. Again, I would point out to you that the Congress made a decision some years ago that you could not have mergers between so-called nondiversified funds. In other words, what was happening is business owners were merging into mutual funds and achieving diversification in that way. The code does not permit that kind of a merger. In other words, you have to achieve your diversification in the merging in company before the merger. I think that is really the primary impediment to the kind of transaction that you are describing. That is, the trust itself would have had to achieve diversification. If it has done that, then in theory, although it might take some patience in the execution, they probably could achieve a merger with a mutual fund.

Mr. **Cardin**. Under existing law or under changes you are suggesting in the banking bill?

Mr. **Gideon**. You couldn't go directly from a trust fund into a mutual fund. If you incorporated your trust, which could be accomplished, and the incorporated institution were itself diversified, then I think under existing law you could get there. It might take you some time to go through the transaction, but you could probably get to that result.

Mr. **Cardin**. I need a followup on this, but we will do it at a later time.

Mr. **Gibbons**. Mrs. Johnson.

Mrs. **Johnson**. No questions, Mr. Chairman.

Mr. **Gibbons**. Mrs. Kennelly.

Mrs. **Kennelly**. Mr. Glauber, I would like to take up the issue of mortgage revenue bonds. I believe you know that this is a continuing issue because we extend mortgage revenue bonds by the year. We don't make them permanent. It comes up every year. Once again that issue is before us.

How come, when I contact Treasury or other members of the administration concerning a reluctance to support the extension, whether permanent or temporary, for mortgage revenue bonds, I get the answer that it is an inefficient way to do business; that the administration, that the Treasury does not favor extension of mortgage revenue bonds?

Yet, when we get into the wholesale situation, when we get into our problems with the banking institutions, we find that one of the things that works in the RTC, one of the success stories we have is that we do see homes moving on the market through the use of mortgage revenue bonds. In fact, I think they account for 60 percent of single-family home sales.

How do you explain your reluctance to support mortgage revenue bonds on the one hand and then on the other hand, the only thing that is working, it seems, in the RTC is the movement of assets that were taken over by the Treasury are mortgage revenue bonds?

Mr. GLAUBER. With your permission, let me ask Mr. Gideon to start the answer. I may hop in after a minute.

Mr. GIDEON. We have not supported extension of mortgage revenue bonds for a long period of time. That has to do with the judgment that we do not believe that they are an efficient use of the Federal tax subsidy.

Mrs. KENNELLY. I know that. I accepted that. But we are in a whole new situation now in the world of these huge number of assets taken over because of the world situation. Here we have an avenue to make some money. Is there any thought on your part to change this? Are we not going to agree?

Mr. GIDEON. I think we are still not going to agree. In other words, the RTC made use of existing law. If Congress, in its wisdom, sees fit to extend it again, the RTC will probably continue to make use of that law. Having said that, we believe that given the overall cost to the Government, this isn't a good transaction. In other words, the administration does not support extension of mortgage revenue funds.

Mrs. KENNELLY. Let me ask the question in another way, Mr. Gideon. If in fact we don't extend the mortgage revenue program and it ceases to exist and we just leave it at that, then when the mortgage facet of the RTC ceases to work in that we cease to have these single homes turn over and get into the hands of people who need them and our liability with this S&L banking situation increases, is it worth that?

Mr. GIDEON. We don't believe the RTC's possibility to market would be impaired. I think the RTC is simply taking advantage of the existing program, which is certainly legitimate for it to do while that program exists. In terms of the overall cost to the Government, we continue not to favor this bond program.

Mrs. KENNELLY. So those houses would just sit on the books?

Mr. GIDEON. I don't believe they would just sit. I think with interest rate improvement we are beginning to see movement in these areas. I don't think that is a function solely of the mortgage revenue bond program.

Mrs. KENNELLY. I know we have disagreed. I just hoped maybe with this change we might agree on this, but I guess we won't. You will argue as you do, and I will continue to argue—I think you have got a new reason for continuing mortgage revenue bonds.

Thank you, Mr. Gideon.

Mr. Chairman, could I ask one other question?

Mr. GIBBONS. Sure.

Mrs. KENNELLY. The cost of recapitalizing the BIF keeps going up. Can you estimate the best we can expect or the worst we can expect in this scenario? Is there a possibility of doing that?

Mr. GLAUBER. I understand your question and desire. To be perfectly frank with you, I don't think anybody can give you a perfect estimate.

What we tried to do, what we did, was to include as part of our testimony the range of estimates that have been put forth by various agencies. They are, very frankly, all over the place. The administration's is in many ways the most pessimistic. I think that is the best we can say.

Chairman Seidman said you can't forecast this very far into the future. As evidence of that, the FDIC doesn't forecast more than 2 fiscal years ahead. I think the best we can do is give you the numbers, the range of numbers we gave you. I can tell you that the plan we proposed and indeed the plan adopted by the Banking Subcommittee is large enough to deal with any of these scenarios and to deal with it with industry money and not with taxpayer money.

Mrs. KENNELLY. I am from——

Mr. GLAUBER. That is the best answer I can give you.

Mrs. KENNELLY. I am from Connecticut, and I am very glad to hear that. Thank you very much.

Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Sundquist.

Mr. SUNDQUIST. Mr. Chairman, I have no questions, but could I yield to Mrs. Johnson for a question?

Mr. GIBBONS. I guess so.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I passed on my time out of necessity, but have a question I would like a response to. How in your proposal do you extend Federal control over State-chartered banks since the State-chartered banks were the site of many of the most serious problems in recent years?

I want you to clarify that issue and then I have one other question.

Mr. GLAUBER. The major change, I think, would be that we say that State banks cannot invest directly in real estate or other investments, even if the States permit it. We say direct investment is an activity we are going to take out of banks. We think that has been one of the major causes of the losses and risk. We think it is inappropriate for banks to do that with insured deposit money, so we say, "no."

Mrs. JOHNSON. And in regard to capital standards, will there be a Federal override of State law in that area?

Mr. GLAUBER. On capital standards? Capital standards are set the same for State and Federal banks.

Mrs. JOHNSON. Could you update us on your negotiations with New Hampshire? I believe that you are looking at ways to inject into the banking system in New Hampshire some greater access to capital to revitalize the system?

My understanding is that you are most advanced in your negotiations with New Hampshire over this subject.

Mr. GLAUBER. I am not the best person to answer that, to be frank, for you. I suspect that the better place to get the answer is the FDIC. I apologize in advance to Mr. Bovenzi for doing this. But I suggest perhaps you would want to ask him because the FDIC is conducting those negotiations. That is an issue for the FDIC, not for us.

Mrs. JOHNSON. I do appreciate that since the FDIC always says that it can't move without your agreement as well. I want to be sure that there is sufficient focus on this subject because, to bring the New England situation back to some greater state of health, there simply has to be some greater ability to capitalize loan activity.

Mr. **Glauber**. To make clear our role, we do sit on the Board of the FDIC. That is to say, two Bureau heads of the Treasury sit on the Board of the FDIC, but the Treasury has no direct authority over those negotiations.

Mrs. **Johnson**. I do understand that, and we are back into the issue of who controls the votes of those two people and what role do they play. It is legitimate and proper that major institutions of the Federal Government move in harmony on such an issue. But this matter has dragged considerably.

It is of extraordinary importance to Connecticut, as well as New Hampshire, that we complete the negotiations to find some new ways to deal with the particular situations that we have there and the combination of factors, regulatory and market, that have conspired to deplete capital. Until you have loan activity, you don't have recovery. So this is very important to us.

I look forward in the very near future to some administrative success in this area.

Mr. **Glauber**. On a related issue, Mrs. Johnson, as you know, the Secretary has been working very hard to make certain that bank regulatory decisions and examination decisions don't stand in the way of banks making good loans. I think we have had some considerable success in that regard.

Mrs. **Johnson**. I do appreciate that. I have to tell you that from the grassroots, the people out there don't see there having been any change with the regulators. I understand that is eclectic. I don't want to get into whether that is true or not true. I don't think either of us is in a position to be certain about that. But the negotiations with New Hampshire are very important and could provide a pattern that could influence Federal activities in other New England States and affect the rate at which the economy turns around. I am very interested in that and will follow that with interest, and hopefully there will be concrete information available to us in the near future.

Mr. **Glauber**. I understand and appreciate your concerns.

Mr. **Gibbons**. Mr. Andrews.

Mr. **Andrews**. Thank you, Mr. Chairman.

I would just like to ask you to go back, Mr. Glauber, and walk us through your rationale and your logic behind the additional borrowing authority of up to $30 billion that the FDIC would be allowed to borrow from the Treasury and the fact that it is exempt from the pay-as-you-go provisions of the Budget Act.

Is that correct? Am I making a correct statement?

Mr. **Glauber**. You are. Any payment in resolutions like the FDIC under current law were determined to be exempt from pay-as-you-go by the Budget Act last year. That would be true, whether the funds were supplied by the Fed or by the Treasury. That is just a fact of OBRA last year.

If you want the logic of what we propose, we believe the banking industry should pay for its own problems. By our estimate, the FDIC is capable of paying for the problems we now foresee. The problem is if you ask the banking industry to pay for it all right now up front, you probably would do more damage than good. You would impose such a large cost on the banks that some of them would actually fail because of that extra cost burden. What we propose to do is to spread that out over a period of time by the usual mechanism of a loan facility, the way a person buys a house. He can't pay for it all up front; so he pays for some up front, borrows the rest, and pays it out over time. Our proposal is that the lender for the mortgage, if you will, would be the Fed. The subcommittee chose to say the lender for the mortgage would be the Treasury.

But the logic, again, is that the banks should pay and will pay, but they can't pay for it all up front.

Mr. **Andrews**. Thank you, Mr. Chairman.

Mr. **Gibbons**. Mr. Grandy.

Mr. **Grandy**. Thank you, Mr. Chairman.

Gentleman, I realize that expansion of banking powers, and particularly Glass-Steagall, is not under the auspices of this committee. However, we had a hearing last week in the Select Revenue Measures Subcommittee involving the collapse of Executive Life of California and Executive Life of New York, and the question of guaranteed investment contracts came up.

My question to you is should we allow the firewalls to come down? We basically are allowing banks and insurance companies to come together. What happens to hybrid products like guaranteed investment contracts? The problem we have had up to this point is that people thought the guarantee was implied and in many States there was little or no guarantee.

I guess my concern is how do we protect investors against banks issuing these products? Mr. Glauber, I will direct that to you.

Mr. **Glauber**. It surely is a very, very reasonable question. First, on specifically those bank insurance contract products, the bill reported out by the subcommittee greatly restricts the ability of banks to sell those products. We supported that. We don't think the deposit insurance money should be used for some of those products.

The question of consumer information is a difficult one. We would require very clear labeling on what products are insured and what products are not insured.

I think one has to be extremely careful on one particular issue. That is the bank selling its own securities in its own bank, the Keating kind of problem. We would prohibit that just outright. We have taken some, I believe, meaningful and appropriate steps to make sure that customers are protected, while at the same time affording a greater range of financial services to customers through banking institutions.

It is a job of trying to balance the benefits and make sure you don't expose the customers to some of the potential dangers. I think we have done that.

Mr. **Grandy**. In other words, you feel that there is enough of a lid on the products the new hybrid entities, banks and insurance companies, could deliver to prevent this kind of peril to investors?

I can tell you this from my own experience in Iowa: we have 7,700 policyholders, annuitants and pensioners who thought they were buying a triple-A rated product and wound up with junk and were not told at any point during the life of the investment what they had.

My greatest concern as somebody who represents a rural constituency is that if the capital flows that way, then I can guarantee you States like Iowa have no interest in banking reform as proposed by Treasury.

This problem happens to coincide with your legislation. I think that is something we are going to have to look at scrupulously.

Let me ask you this, Mr. Gideon. How do we tax financial products of these businesses? If we allow some of these kinds of products to come forward, that banks and insurance companies might be able to market, do you foresee any kind of change in tax structure and how they would be taxed?

Mr. GIDEON. There would be no changes as a result of this bill. Obviously, insurance products are taxed differently from the financial products of banks, but the bill does not propose a change.

Mr. GRANDY. So an insurance product sold by a bank would still be taxed as an insurance product, regardless of who the vendor is?

Mr. GIDEON. That is correct. And in point of fact—Mr. Glauber, perhaps you would answer this—as I understand the bill's provisions, to engage in the insurance business, the bank, as I understand it, would have to have an independent subsidiary.

Is that correct?

Mr. GLAUBER. That is correct.

Our approach is really two pronged. First, we restrict the kinds of products banks can sell backed by insurance dollars. Second, we certainly allow those products to be sold by an affiliate where it is not backed by insured dollars, but we require it to be labeled. So there would be no backing by insured depositors' dollars. They would be labeled for what they are.

Mr. GRANDY. Let me probe that a little bit. Under what I understand happened with First Executive, they were using State funds, and it is a matter of chance how much the State fund may have to protect the loss under First Executive. As we understand it right now, the PBGC is saying we are not involved, and we have no authority.

But I guess my concern is, what happens with State insurance laws if we are now selling national kinds of investments? Do the State funds kick in? Is there a new need for a trust fund? Do we, under this law, have to federally regulate the insurance industry and repeal or modify McCarran-Ferguson?

Mr. GLAUBER. That is something the Congress can or will consider. We do allow insurance companies to affiliate with banks through a holding company. I think it is a perfectly worthwhile enterprise to consider whether we ought to regulate insurance companies differently than the way we do.

But our bill, as a banking bill, really doesn't reach that issue.

Mr. GRANDY. I thank you gentlemen for providing input on that.

Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. McDermott.

Mr. McDERMOTT. Thank you, Mr. Chairman.

Some wag has suggested that the problem with Congress today is C-Span. I am here to report to you that the phone calls are already coming in from my district suggesting that I vote against this bill.

Now, when I arrived in Congress 2 years ago, I was put on the Banking Committee, and I listened to all the reasons why the savings and loans failed. A major reason was deregulation. I returned to my district on two different occasions to meetings with several hundred angry people at a junior high school, talking about that very issue.

Since you won't be there with me when I go home to explain the money we are being asked to vote for to bail out the banking industry, could you give me an explanation of why expanding powers is going to solve the problem of the banking system—something an ordinary citizen of the United States can understand.

Mr. **Glauber**. First, I would start out by saying, we are not giving $45 billion to bail out the banking industry.

Mr. **McDermott**. It would be hard to make that case.

Mr. **Glauber**. I would hope to try and help you, because—again, let me emphasize—this is money the banking industry has intended to repay. All the estimates by the credible people looking at this say they can and will repay it.

Mr. **McDermott**. What period, 30 years?

Mr. **Glauber**. Actually, in the structure, I think, that the FDIC is looking at, it is something on the order of five to 20 years, depending on how much is borrowed.

The way this would be done is, if money were borrowed, the FDIC would raise and dedicate future premiums to the repayment of that money. So they would dedicate a premium flow to repaying that money—that premium flow, of course, coming from the banks.

As to how the modernization we would propose would help the banks, the first thing I would emphasize is that we really have learned from the past. What we are proposing here is not that banks engage in broader activities in the bank the way S&Ls did and put insured deposit money more greatly at risk; what we are proposing is that they be allowed to affiliate with companies that engage in these activities, but that companies are separate, and that insured deposit money, with its backup guaranteed by the taxpayer, is not put at risk. And as a further form of insulation, we would permit only highly capitalized banks to engage through affiliates with these new activities.

Why do we think this makes sense? Because the world has changed enough that the distinction between commercial paper, which is a product sold by a securities firm, and a bank loan, which is a product sold by a bank, has blurred so much that there really is no distinction.

We do not allow these new activities to go on inside the bank. That was the mistake we made with the S&Ls. We shouldn't have made that mistake.

I think that is the best answer I can give you.

Mr. **McDermott**. Let me pursue that for just a second.

I can imagine some Norwegian fisherman standing up and saying, look, I remember when the banks failed in the 1920s, and they came around with this Glass-Steagall Act; and now you want to get rid of it. Aren't you just opening the door up?

You say you have got these firewalls. Are there some banks that you would let fail if they foul up?

Mr. **Glauber**. Yes, absolutely.

Mr. **McDermott**. Big banks?

Mr. **Glauber**. Yes. One of the issues, as you suggest, is whether or not we would let a truly very, very large bank fail.

Mr. **McDermott**. We haven't done it yet. We had Seattle First, which didn't fail.

Mr. **Glauber**. Indeed, I think that we have to have a system where uninsured depositors know that their money is at risk. I think it is not right to say that we treat large and small banks differently. The proposals in our bill would change that. The proposals in the bill actually voted out by the subcommittee would change that. Whether or not we should say we would never intervene to protect uninsured depositors in a failure that threatened the health of the financial system is a question that can be debated. We say that we ought to allow residual authority to the Fed to intervene in a crisis. Other people would say, even then you shouldn't allow them to intervene. It is just unfair to say, in some cases they might and some not. That is a debatable point.

Mr. **McDermott**. The bill that came out of the Banking Subcommittee says they will exempt 92 percent of the banks from CRA. That sounds like a step back to redlining to me; does it to you, and do you support it?

Mr. **Glauber**. I would say it isn't a step back to redlining. What the bill says is that banks that have a high rating for their CRA performance would be exempted, but only those that have performed well. So you have to perform well before you would be exempted. I don't think it is a step backwards.

Mr. **McDermott**. Thank you.

Thank you, Mr. Chairman.

Mr. **Gibbons**. Mr. Archer.

Mr. **Archer**. Thank you so much for coming and giving this committee an opportunity to question you and learn more about the proposals. Our jurisdiction, as you know, is very limited in this area, but it is helpful for us to get the benefit of your input.

I would like to follow up on the question Mr. McDermott asked. You have the power today to let a bank fail. You don't need new statutory power. Why is it we are not seeing this implemented administratively if, in fact, too-big-to-fail is not a good policy?

I personally have some very serious questions about the too-big-to-fail policy, particularly because of how discriminatory it is relative to different depositors and different institutions. Why have we not permitted some of the larger banks to fail?

Mr. **Glauber**. I think it is, Mr. Archer, discriminatory. I think it is not a good policy as it is currently being operated. I think it needs to be changed, and we propose to change it. I think we are locked in a vicious cycle.

What has happened is that people have come to expect that all deposits will be protected in most bank failures, because we, in fact, protect 99.5 percent of deposits of bank failures. So they are just working off of past history.

To cite an example, Bank of New England failed recently. When it did, there was about 3 billion dollars' worth of uninsured deposits there, which ultimately were protected at an additional cost of maybe $300 to $400 million. That money was not there because it was asleep at the switch. People knew the Bank of New England was in serious trouble. It was there because it was being offered high rates of return, high deposit rates, and the depositors were betting, when push came to shove, we would protect those deposits. And they bet on the basis of past evidence.

We have to break this cycle where people expect they are going to be protected, even though they are not officially protected. That's why we propose to change the system entirely as to how bank regulations would be done.

We would say to the FDIC, you only do insured deposits; you don't do uninsured deposits. Some people would say, that's the end of it; we will never do another uninsured deposit. We went one step further and said, we think the Fed and the Treasury should have the right to override that decision in extreme emergencies, because there may come a time when you want to be able to override that, but only very, very infrequently and only by a different body with the perspective of the entire economy.

I think that is the right way of ending most all of the inequity that exists now, but still preserve some flexibility so that, in an extreme emergency, the responsible financial authority can intervene. I would expect that would be extremely infrequent, a very rare event, but I think it ought to be one last weapon in the arsenal to deal with financial crises.

Mr. ARCHER. Is this a regulation now in effect?

Mr. GLAUBER. No. This is a proposal under our legislation.

Mr. ARCHER. Why do you need new legislation?

Mr. GLAUBER. Because right now the FDIC is, in fact, required not to consider the full range of resolution mechanisms and is, in fact, under the current law, permitted—as it does—to pay off virtually all deposits.

This bill would change the standard by which the FDIC makes its decision on what to pay off.

Mr. ARCHER. You have a great relationship with Bill Seidman. Could you not go to the FDIC and say, hey, we think this is a bad policy, so why don't you do it differently, and then have some mutual, joint announcement so the world will know what is going on?

Mr. GLAUBER. To some extent the answer to that is "yes." In the Bank of New England, the FDIC could have not paid off all deposits, and the Treasury could have gone to the FDIC and said, we think you should do that. I think because people expect everything will be paid off, they behave that way.

Mr. ARCHER. I don't want to belabor this any more because I have one other specific question I would like you to respond to, and it concerns the expanded use of Social Security numbers.

I personally find that the language in section 101 is ambiguous. Does "depositor" refer to the person depositing the funds, or, if different, to the person whose name is on the account? Let me give you an example.

If I were to deposit money in my child's account, whose Social Security number would be required?

Mr. GIDEON. Well, Mr. Archer, I assume that there would be every effort made to conform to the rules that govern interest-bearing accounts already under the tax provision, so that this would not be doubled up. We perhaps should get back to you on the specifics of that, to make sure that I am not stating that in error.

Mr. **Archer**. So you are not at this point able to answer my specific question?

Mr. **Gideon**. I am not. That is correct.

Mr. **Archer**. Is someone in the Treasury, who is involved in these proposals, able to answer that question?

Mr. **Gideon**. I think so, and we will get back to you.

Mr. **Archer**. Let me tell you the problem I have. Doesn't the bank already have that information? And what is the intent of this provision?

Mr. **Gideon**. I think this is a very minor provision that covers one gap in the procedures of the FDIC. As I pointed out earlier, the bank already has the information with respect to interest-bearing accounts. This would make sure that that information is gathered across the board, so that it could be used as a way of enforcing the $100,000 limit.

Mr. **Archer**. If you would get back to us with an answer to my specific question, I would appreciate it. Thank you.

[The following was subsequently received:]

Mr. Archer asked Mr. Gideon a question about a provision in the administration's banking proposal during his testimony before Ways and Means on the proposal. This responds to your question, although it is worth noting that the provision you questioned is not in the banking bills recently passed by the House and Senate Banking Committees.

The provision you questioned provided that "[a]ll deposits shall be registered under the taxpayer identification number or employer identification number of each depositor." *See* section 101(b)(1)(B) of the administration's proposal. Mr. Archer asked:

"Does 'depositor' refer to the person depositing the funds, or, if different, to the person whose name is on the account? Let me give you an example. If I were to deposit money in my child's account, whose Social Security number would be required?"

In general, the proposal would have required that all accounts be registered under the taxpayer identification number ("TIN") of the person named on the account. In your example, for instance, the account would have had to be registered under the Social Security number of your daughter.

As Mr. Gideon testified, generally the same persons who currently are required to furnish their TINs in connection with interest-bearing bank accounts for tax purposes would have been required to furnish their TINs for bank insurance purposes. As a result, this provision generally would have imposed an additional registration burden only on those persons who have bank accounts that do not bear interest and, therefore, are not currently subject to tax reporting rules.

In some circumstances, however, it may have been advisable to require persons with interest-bearing accounts who are not currently required to furnish their TINs for tax purposes to furnish them for bank insurance purposes, to assist in applying the dollar limit on deposit insurance coverage. For example, the tax rules only require the TIN of one of the two owners of a joint account. It may have been advisable for bank insurance purposes to require that the TIN of each joint owner be supplied, since the limit on deposit insurance is applied separately to each joint owner. Some other differences between the reporting of TINs for tax and bank insurance purposes may have been desirable; for example, in the case of certain employee benefit arrangements.

Mr. **Gibbons**. Mr. Rangel.

Mr. **Rangel**. Thank you, Mr. Chairman.

The FDIC mentioned my little bank on 125th Street, and on very short notice, you were polite enough to respond. And now everyone is talking about the inequity of the system. But as I feel the pain of having lost a community bank, the only thing I hear you say is that you are going to be equitable in closing big banks. I don't see any equity at all, as relates to depositors, in community banks.

Now, most of us that cared about this bank would encourage anyone doing business in our community to make deposits there. We were not seeking higher interest; we were not thinking that the FDIC was going to bail them out. They were not risk takers. They were people investing in an economically depressed community and felt they could do better, get along better, if they showed confidence in our little bank. We were encouraged to do that. We even had Treasury make deposits in the bank. So clearly, we weren't trying to rip off the system.

Now, most of the people that really went out of their way to support this federally insured bank were hospitals, churches, nonprofit, low-income housing projects; and the Federal Government never even considered sharing with anyone in the community that our bank was in trouble. Now, your face would indicate, shame on me, because obviously the record would indicate that someone in the community must have known. And if you believe that the color of a board member's skin is sufficient evidence to believe that he is a member of the community, then you have got that right.

But if I were to tell you that not one member of the board of directors of Freedom National Bank lived in the City of New York, would you not remove the frown and say that the community didn't know?

Now, I don't know whether I am supposed to know the board members' addresses, but somebody should. And they all had funny types of addresses; each one of them lived in Washington, D.C., Connecticut, and New Jersey. And your shop knows they were wheelers and dealers; they were the ones looking for the high returns.

So my question is, in terms of equity and fair play, what happens to the depositors? What happens to the community?

Mr. GLAUBER. I think it is a very fair question.

Any banking system that has the level of failures that occurs in our banking system is going to lead to inequities. I think the answer is to reduce the number of bank failures by using higher Federal standards. When we don't have a bank failure, we don't have to worry about which deposits to pay off and which deposits not to pay off.

We should return the level of failures to something like what we used to have. In the 38 years before 1980, the total number of bank failures was 198—the total number. In 1989 alone, we had 206 bank failures in the one year. They have been running around 200 a year. That seems to me an intolerable situation.

Mr. RANGEL. Where is the equity with the churches and the nonprofits? Who was negligent in the community not knowing that the bank was in jeopardy?

Mr. GLAUBER. That is just the point, Mr. Rangel. We have to have a system of supervision, so we don't reach the failure level. Once we do, then we face the kinds of problems you raise of when do you pay off all deposits and when don't you. If you make a choice to do it sometimes and not other times, you inevitably are going to have the question raised, as you quite correctly raised it.

Mr. RANGEL. Is there any way you could support holding nonprofit organizations harmless if I can prove to you that none of your board members, because they certainly weren't my community board members, notified the community that the bank was in jeopardy or that they were trying to sell the bank?

Mr. GLAUBER. We face the question of whether we should insure some deposits or all deposits. What we have said is, we will insure them up to some limit. We could make the decision to insure all deposits, regardless of any limit. The problem is that, if you draw the line there and if you move it toward insuring all deposits, I don't think there is a bank insurance fund large enough to act as a buffer between the banks and their failures with the taxpayers. We have to draw the line somewhere.

Mr. RANGEL. I am trying to say, the Federal Government should share some of the responsibility for the way this matter was handled. And if you look at the facts and if what I am telling you is true—and we had hearings based on this, and I knew these people, and it never entered my mind that they had told the Federal Government that they lived in Harlem, much less in the City of New York, because I know where they live.

Now, you don't see where we could make exceptions where the Federal Government never checks out where the board came from?

Mr. GLAUBER. Again, I think we are agreed on this. A solution to this problem is more effective banking supervision and oversight.

Mr. RANGEL. I agree with you. That is for the future. But what can I do about those people that got caught in this bad policy?

Mr. GLAUBER. I think it is a very unfortunate outcome of what was meant to be an effective policy, but it needs to be strengthened.

Mr. RANGEL. If I introduced a bill to hold these people harmless, would you support that—just the nonprofits?

Mr. GLAUBER. The problem, I think, is that if we extend the safety net further and do it on this kind of selective basis, we will end up with a situation where there just isn't a big enough insurance fund to——

Mr. RANGEL. Thank you very much.

Mr. GIBBONS. Are there further questions for these gentlemen?

Mr. GUARINI. I would like to just ask a question as to—you made reference to the fact, in your statement, that the FDIC uses a least costly method to resolve the insured bank's problem. And in making these least-cost determinations, you say there are a number of tax deductions and advantages and incentives that have been passed in the past that are used. You mentioned bad debt deductions, ordinary income treatment, foreclosure gain and loss, and credit unions' provisions in your statement.

I am wondering in making these least-cost determinations, what do you rely on principally, which sections of the code do you use the most in coming to your determinations?

Mr. GIDEON. This is not a determination we would make, Mr. Guarini. What the bill requires is that the regulatory agency that is making the resolution, or the FDIC, would take into account the tax costs of the resolution, as well, in terms of forgone revenues, and treat that as a loss to the fund in determining what is the least-cost resolution. That is a proposal in the current legislation.

Mr. GUARINI. The least tax expenditures, I am just wondering, are there some provisions that are more tempting than others? Are there some provisions that you rely upon as more consistent with your conclusion of the least-cost determination than others?

Mr. **Gideon**. I am not sure that I fully follow the import of your question. I think that all this provision is intended to do is to cause the regulators to take into account that if they are making a determination as to which would be the least costly resolution method, that revenues forgone would be an issue in making that decision.

I would suppose that net operating losses of these institutions are frequently available in making that determination, but I think it would vary on an institution-by-institution basis.

Mr. **Glauber**. Maybe I can be a little helpful here.

Our bill requires that the FDIC look at all the resolution options. First, it could simply pay off the insured deposits, send a check to the insured depositors for $100,000 or whatever it was.

Second, they could sell to another bank the insured deposit base. And third, they could sell to another bank the total deposit base, including uninsured deposits.

In choosing among these three options, one of the considerations might be tax considerations; and all this provision of the bill says is that they should, in making the determination which is the cheapest, to consider the tax implications as well.

Mr. **Guarini**. That sounds reasonable, because I go back to the days of Danny Wall, when a lot of tax advantages were given to different FSLIC problems, and apparently it was very costly to our Government; and in fact, that he took what was the most costly factors in coming to a conclusion. And, of course, this was a tremendous giveaway of billions of dollars of taxpayers' money.

I am glad to hear they are going on a least-cost determination. My question was only as to which particular sections of the code you thought gave most impetus or would be used most under today's circumstances.

Mr. **Gideon**. I think, again, I would have to reiterate that would have to be an institution-by-institution interpretation, but loss carrybacks would probably figure prominently in that analysis.

Mr. **Guarini**. You mean, the 10 years back and the 5 years forward?

Mr. **Gideon**. The ability to utilize net operating losses from a prior period.

Mr. **Guarini**. Which distinguishes the advantages you give an individual, as opposed to the banks, which have special considerations?

Mr. **Gideon**. In some respects, there is a slightly different rule for banks. In general, the rules, for the most part, are similar.

Mr. **Guarini**. Except you go 10 years back for a company and 3 years back for an individual.

Thank you.

Mr. **Pickle**. Mr. Chairman, I would like to ask a question.

I am just trying to reach an understanding about what you recommend here today. What you are proposing is that the FDIC get up to $25 billion from the Federal Reserve. You indicate from your statement to me that that $25 billion would not be subject to Federal debt limit; is that correct?

Mr. **Glauber**. That is a complicated question. Let me step back and say, if the borrowing were from the Treasury, it would be subject to the Federal debt limit; if the borrowing came from the Fed, it might or might not be. And it depends on whether the Fed took actions after it loaned the money to the FDIC to borrow further.

Mr. **Pickle**. Borrowing from the Treasury, wouldn't that be the cheapest of all?

Mr. **Glauber**. I think it would be the same cost, either way.

Mr. **Pickle**. I am trying to get your position. Are you saying to me, you could get the $25 billion from the FDIC or the Federal Reserve and it would not be subject to the Federal debt limitation? Would it or would it not?

Mr. **Glauber**. It depends on what actions the Fed took as part of its loan to the FDIC. If the Fed borrowed further, it would be subject to the debt limitations. In terms of costs, the cost would be effectively the same.

Mr. **Pickle**. I think you are begging the question. I just simply want to know, if you did borrow it—you recommended the FDIC from the Reserve—would it or would it not be subject to the Federal debt limitation? You seem to say "yes" and "no.".

Mr. **Glauber**. I have to say that. It could be, but it might not be.

Mr. **Pickle**. The money would be repaid through raising premiums up to a cap of 30 cents on $100.

Mr. **Glauber**. The number is $25 billion that would be borrowed for loss.

Mr. **Pickle**. $25 billion. Now, how do you arrive at the figure of 30 cents level per cap? It is the first time you have ever put a cap on it. Is that an arbitrary figure from you or from the Banking Committee or from the BIF factor?

Mr. **Glauber**. The cap was removed by Congress last fall. It was a cap of 32.5 cents that was removed. The logic for it is this. All the banking regulators agree that if you raise premiums beyond some level, you are going to do more damage than good. Premiums will be so high and the cost so great on the banks that you will cause more bank failures.

Mr. **Pickle**. I don't think any of us know whether 30 cents is the right level or should be higher or lower. Do the banks agree across the country that they would be willing to pay the extra premium?

Mr. **Glauber**. No, I don't think the banks across the country agree on anything. Some of them do, indeed, agree that 30 basis points is in the right range. Some feel it should be lower.

The best judgment I can give you is the judgment of the FDIC and of the Chairman of the Federal Reserve Board, both of whom believe that numbers in the range around 30 basis points may be getting too high.

Mr. **Pickle**. Some of us have heard from banks who are not going to be happy about that. They are hanging on by their finger nails right now.

How long would it take the FDIC to pay back this money on the basis of 30 basis points?

Mr. **Glauber**. I think their plan is to raise it dollar for dollar by raising premiums enough to pay that premium back over a 15- or 20-year period.

Mr. **Pickle**. That is a long time. And that assumes everything fits into place.

Mr. GLAUBER. Well, that's right. Again, as I said to Mr. Andrews, the policy problem you have is how long you want to spread it out. If you ask them to pay for it all up front, I think you do too much damage.

Mr. PICKLE. This is working capital. You wanted $45 billion in working capital. You say, well, not all of it is based on the assets, but a large portion of it is.

Now, assuming that banks go under and assuming that you use this money, the first question would be, can you sell the assets to take care of the working capital?

Mr. GLAUBER. The answer is yes, you can sell them. The question is, as you suggested earlier, at what price?

Mr. PICKLE. Yes. On the one hand, you have got all these assets of savings and loans out there that have not been sold, have not come anywhere near to your projections of September 1990. You told me then, RTC had sold about 6 to 8 percent of the assets, and soon we are going to have it all sold.

So you indicated then it would go well and now it hasn't. The fact of the matter is, it has not gone well. Now you are going to be putting the banks' assets out for sale. That means twice as many assets competing, would it not?

Mr. GLAUBER. Not twice as many, but it would add to the inventory.

Mr. PICKLE. That means some of these assets are not going to be as good as they were 1½ years ago.

Mr. GLAUBER. I think the chances of selling these assets depends on what happens with the economy and the real estate industry.

Mr. PICKLE. I have insisted over and over again that you have got to put in place a good seller financing program, some kind of program to encourage sales; and slowly, gradually, between the RTC and the Treasury, and the Oversight Board, you finally put into place a seller finance program. And it is not working too well. Apparently, there is some difficulty getting a 15 percent downpayment.

Now, I think we ought to have a seller financing program. I don't think you are going to sell these assets. But you seem to just do it the slowest way, the hardest way, because you don't want to have the problem come back to you and you don't want to get criticized again. I understand that, but it looks to me like the sale of assets and return of working capital is not going to happen.

You have got to liberalize your seller financing program some way or another, or else this program is just a recommendation. I say to you, whatever you do, you ought to be on the budget. It ought to be subject to Federal debt limitation. That is what I think we will insist on.

I do think that you should consider a more liberalized financing program to move the assets that come onto the books. That remains to be seen, but I think it has to be taken into consideration. Do you agree?

Mr. GLAUBER. You have certainly proven correct that in order to move these assets, we had to liberalize our financing programs. And as you said, the RTC now requires 15 percent down and extends 85 percent credit. I think that that has proven necessary.

You are right, also, that the RTC moved to that, I guess, grudgingly. They would like to get as much down as they could. They proved we had to go to 15 percent down.

Mr. PICKLE. If we do not sell the assets, the sobering fact is that it costs the taxpayer.

Mr. GLAUBER. There is no question.

Just to repeat the other side of the issue, which I know you know very well, if you require too little money down, then the buyer has not a great deal of interest in working the assets. So it is clearly a hard judgment.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. GIBBONS. If there are no more questions, we will say goodbye to this panel and pick up another one here.

We have the FDIC next. You may proceed as you wish.

STATEMENT OF JOHN F. BOVENZI, DEPUTY TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. BOVENZI. Good morning, Mr. Chairman, members of the committee. My name is John Bovenzi. I am Deputy to Chairman Seidman at the FDIC. I appreciate the opportunity to discuss the condition of the Bank Insurance Fund and to present the Federal Deposit Insurance Corporation's views on recapitalization of the fund, and the necessary protections for the deposit insurance funds.

I will present the FDIC's estimates of the future condition of the Bank Insurance Fund. Let me, however, make it clear that these estimates are dependent on future economic conditions. These conditions have changed in the past and are likely to change in the future.

Over the past 4 years, 800 banks with about $140 billion in total assets have been closed or reserved for. These failures have cost the Bank Insurance Fund $23 billion. Over the same period, the fund has generated $14 billion in revenue. As a result, the Bank Insurance Fund declined from $18.3 billion at yearend 1986 to $8.4 billion as of yearend 1990. The 1990 figure is preliminary and subject to further change based upon our ongoing discussions with the General Accounting Office.

Attempting to make an informed judgment as to the future condition of the Bank Insurance Fund requires making a series of projections regarding all the factors that influence its costs and revenues. In particular, forecasts must be made regarding the likely state of the national, regional, and local economies and real estate markets, the likely impact of these events on bank losses, the number of bank insolvencies, and the probable cost of these insolvencies. In short, the condition of the Bank Insurance Fund is dependent on a complex series of events that is impossible to forecast with any degree of confidence. Thus, it is subject to considerable uncertainty.

Despite such uncertainties, projections are necessary to assess the best course of action. The FDIC has made two projections, a baseline estimate which assumes a gradual economic recovery over the next few months and a pessimistic estimate which assumes the recession will continue throughout 1991. Based on these assumptions, our supervisory staff projects a total of 340 to 440 bank failures in 1991 and 1992 combined. These failures are projected to cost the Bank Insurance Fund $16 to $24 billion. Over the same period, the fund is expected to generate about $12 billion in revenue. As a result, by yearend 1992, the Bank Insurance Fund is projected to have a balance anywhere between a positive $3.6 billion under the baseline scenario and a negative $4.6 billion under the pessimistic scenario.

Over the past few months, our experience and expectations had been much in line with the baseline scenario. However, our present expectations place us somewhere between the two scenarios. The longer the recession continues, particularly if it extends into 1992, the further we are likely to move toward and perhaps beyond the pessimistic scenario. Clearly, without recapitalization, the Bank Insurance Fund could well become insolvent.

Regardless of whether or not the fund becomes insolvent, the FDIC will have to borrow for working capital purposes. These borrowings can be paid back as the FDIC sells the assets it takes over from failed banks. Under the baseline projection, the Bank Insurance Fund will need to borrow $18 billion by yearend 1992. Under the pessimistic projection, new borrowings will reach $40 billion.

The FDIC's present statutory borrowing authority is nine times the fund's net worth. Thus, current borrowing authority exceeds $70 billion. However, this amount will decline as the fund's net worth declines. This raises the question, at what point will the FDIC need new legislation in order to borrow? Under both the baseline and pessimistic scenarios, the FDIC will be able to borrow enough to meet its working capital needs at least through fiscal year 1991. Under the baseline scenario the FDIC may need no new borrowing authority for 1991 and 1992, but there will be little margin for error. Under the more pessimistic scenario, we will need expanded borrowing authority late in 1991 for working capital needs and would require substantial new borrowing authority to cover losses and working capital needs in 1992.

The Treasury Department has proposed in H.R. 1505 a longer term funding plan that requires the banking industry to fund certain obligations of the FDIC—no taxpayer money is requested. The FDIC Board has reviewed the Treasury's recommendations to recapitalize the Bank Insurance Fund and endorses the proposal.

The Treasury's proposal is a contingency plan, a total of $70 billion in standby borrowing authority would be available if needed. Of this amount, $45 billion would be for working capital to purchase from failed banks certain real estate and other nonliquid assets at their estimated true economic value. Any borrowings for working capital would be paid back as these assets are sold. The remaining $25 billion would be available to absorb insurance losses, and would be repaid by the banking industry through dedicated insurance premiums.

Presently, the FDIC has a $5 billion line of credit at the U.S. Treasury. The Treasury's proposal would authorize the FDIC to use that line of credit as a base to borrow up to nine times that amount; under current law, the FDIC can borrow up to nine times its net worth. Therefore, the Treasury's proposal would result in the ability to borrow up to $45 billion. This is the borrowing authority that would be used to provide working capital.

The Treasury also has recommended that the FDIC be given the authority to borrow up to $25 billion from the Federal Reserve. This borrowing authority would be used to cover insurance losses as required. Thus, this plan does not require banks to cover the losses in the fund immediately since such additional costs could delay the recovery of the industry and the economy. Instead, the FDIC could borrow from the Federal Reserve or other sources and increase insurance premiums in order to repay the borrowing over time as the economy recovers.

Three principal merits of the proposal deserve emphasis:

First, the plan provides adequate resources to deal not only with the FDIC's most pessimistic scenario, but with those of CBO, GAO, and OMB as well.

Second, the plan does not impose needless burdens. Money will not be borrowed unless it is needed.

Finally, the plan does not require taxpayer funding and does not cripple the banking industry.

The FDIC believes that the drain on the insurance fund from bank failures must be fixed as part of providing for a recapitalization of the fund. We cannot afford a system that is as costly as our insurance system is today. Broad structural reform is essential to a safer and sounder financial system. More funding to recapitalize the Bank Insurance Fund will be wasted if fundamental flaws are not repaired.

The objectives of reform should be to maintain the stability of the financial system, to reduce the potential liability of the Government for its safety net and to ensure that the banking industry bears the appropriate costs of insurance.

The independence of the regulators and insurers also is essential to a sound financial regulatory system. Nothing in our recent history suggests that we need less independence of regulators or less regulatory and supervisory activity with respect to banks. Too much conservatism in the pursuit of a sound financial system has not been our problem.

Thank you, Mr. Chairman. This concludes my statement.

[The prepared statement follows:]

TESTIMONY OF
JOHN F. BOVENZI
DEPUTY TO THE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Good morning, Mr. Chairman and members of the Committee. We appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation on current banking reform proposals.

Our testimony will discuss the condition of the Bank Insurance Fund and the need for recapitalization of the Fund. In addition, we will discuss various aspects of H.R. 1505, the Treasury Department's proposal to reform the banking industry and the deposit insurance system.

There has been some confusion about the estimated money required to recapitalize the Bank Insurance Fund (BIF). We will present the FDIC's estimate of the future condition of the BIF. Let me, however, make clear that these estimates are based on moving numbers of projected bank failures largely dependent on future economic conditions. These conditions have changed in the past and are likely to change in the future. We will also explain the Administration's plan for ensuring the continued health of the BIF. The Administration, in conjunction with the FDIC, has developed a plan to ensure the continued adequacy of the BIF to protect depositors against possible losses stemming from bank failures. The banks will meet the cost of the plan through payment of increased premiums. Taxpayer money is not required.

Bank Failures and the FDIC's Need for Liquidity

Before proceeding further, it will be useful to give a hypothetical example of how the FDIC might handle a bank failure in order to clarify some of the terms used in this testimony. More specifically, we want to ensure that our use of the terms insurance losses, fund balance, borrowing and working capital is clear. Suppose a bank fails with liabilities of only $100 in insured deposits. The bank has assets with a book value of $100, but a present value of only $90. Therefore, FDIC's sale or liquidation of this failed bank results in an insurance loss of $10 equal to the bank's negative net worth. This transaction results in a reduction in the BIF's fund balance (also known as net worth) of $10.

Typically, not all the $100 of assets would be of impaired value. Suppose about $60 of the original $100 are sound assets worth 100 cents on the dollar, while the other $40 are nonperforming assets worth 75 cents on the dollar. Suppose it is less costly to the FDIC for an acquirer to assume the $100 in deposit liabilities in exchange for the $60 of "clean" assets, and an additional cash payment from the FDIC of $40. Thus, the FDIC has funded the purchase of the $40 in "bad" assets from the failed bank (which, of course, are worth only $30 -- the difference being the unsecured loss).

If the FDIC financed this transaction entirely from its own resources, its net liquid assets would decline by $40, and its non-liquid assets, an account receivable from the liquidating receivership, would increase by $30, reflecting the net value of the receivable remaining after subtracting an allowance for loss of $10. The net result would be a $10 decline in the BIF's fund balance. The crucial point is that the less costly transaction may require that the initial outlay ($40) be much more than the insurance loss ($10) related to the failed institution.

If the FDIC borrowed the $40 to finance its initial cash outlay, BIF liabilities would increase by $40, and again its net receivables from bank failures would increase by $30, resulting in a $10 decline in the fund balance. One can think of the $40 borrowing as divided into two components: $10 to pay for the insurance losses related to the failed bank, and the other $30 which will be recovered by the FDIC over time as the assets are sold. This portion of the initial outlay which is expected to be recovered therefore reflects liquidity needs (called working capital), not losses to the BIF. The portion of the initial outlay which is not recovered is the insurance loss and is paid through insurance assessments; the BIF fund balance is simply the accumulation of past insurance assessments.

CONDITION OF THE BANK INSURANCE FUND

Preliminary, unaudited financial reports for 1990 show that the BIF had an operating loss of $4.854 billion, bringing the size of the fund down 37 percent from year-end 1989 to $8.356 billion. The BIF now has about 42 cents in reserve for every $100 of deposits insured.

Total revenues increased by 10 percent to $3.9 billion in 1990. This increase was due primarily to a 52 percent increase in assessment income resulting from the statutory increase in assessment rates from .083 percent to .12 percent of assessed deposits for 1990, offset by a 38 percent decrease in investment revenues.

The number of bank failures decreased from 207 in 1989 to 169 in 1990. Insurance losses of $8.5 billion were charged to the BIF in 1990, although $3.4 billion of this represents estimated costs of bank failures in 1991. As of today, 53 banks have failed this year.

Cash and U.S. Treasury obligations decreased by 50 percent in 1990 from $13.7 billion to $6.9 billion and now represent about 42 percent of total assets of the BIF. A significant portion of this decrease ($3.6 billion) was related to money needed for working capital to handle closed banks.

Since these results are just now being audited by the General Accounting Office, they are subject to change. However, our experience has been that any major issues resulting from these audits have been related to the timing of when to book the losses from future bank failures. As indicated above, we have already shifted $3.4 billion in anticipated losses to 1990 for banks actually not expected to fail until 1991. An example of this recognition of losses in 1990 for a 1991 failure is the Bank of New England.

The loss for 1990 represents the third consecutive year that the BIF has reported an operating loss. Most observers of the banking industry and the insurance fund agree that both face challenges not encountered since the inception of federal deposit insurance in 1934. Attempting to make an informed judgment as to the condition of the BIF requires making a series of projections regarding all the factors that influence costs and revenues to the BIF. In particular, forecasts must be made regarding the likely state of the national, regional and local economies and real estate markets, the likely impact of these events on bank losses, the number of bank insolvencies and the probable cost of these failures. In short, the condition of the BIF is dependent on a complex series of events that is impossible to forecast with any degree of confidence. Thus, any projection of the future course of the deposit insurance fund -- and, hence, the current condition of BIF -- is subject to considerable uncertainty. It should be noted that our forecasts have changed in the past and clearly will change in the future. Nevertheless, it is important for the FDIC and other interested parties to try to assess the condition of BIF.

The FDIC for the past several years has prepared an estimate of bank failures for internal planning purposes. In contrast to projections of outside parties that are based on modeling, the FDIC's estimates for banks over $100 million in assets are based on a bank-by-bank analysis performed by our supervisory staff in the field using examination reports and our off-site "CAEL" early warning system which looks at capital, assets, equity and liquidity. Clearly, this exercise has become more important as the system and the BIF have come under increasing stress.

Earlier this year we completed a review of likely failures for calendar years 1991 and 1992. The review covered just those two years because our experience has taught us that projecting banking conditions beyond six to eight quarters involves so much uncertainty as to render the results almost useless. We instructed our bank supervisory staff to identify banks they believed would have a greater than 50 percent chance of needing FDIC financial assistance during 1991 or 1992 under two different economic scenarios: a baseline case that assumes a moderate recession ending by mid-year 1991; and a pessimistic case that assumes a recession that lasts for more than one year. We did not attempt to project best-case or worst-case scenarios. Our present expectations for the future fall somewhere between the two scenarios.

As indicated earlier, the condition of the BIF is highly dependent on economic conditions. If the current recession deepens or extends well into 1992, the results for the BIF could be substantially worse than under the pessimistic scenario.

Attached as an exhibit to this testimony (Attachment 1) is a summary of the results as well as a BIF liquidity analysis and statistics on the number of and assets in banks officially designated as problem institutions. For comparative purposes a summary of the differences between the projections of the FDIC, the Congressional Budget Office (CBO) and the OMB is included (Attachment 2). It should be noted that for the years 1991 and 1992, the FDIC's pessimistic scenario is more conservative than both the CBO and OMB projections. The FDIC's baseline case results in a fund balance of about $4.1 billion at year-end 1991, and a $3.6 billion balance at year-end 1992. The pessimistic case results in a $0.2 billion fund balance at the end of 1991, a deficit of $4.6 billion by year-end 1992. Both cases assume that the premium assessment rate is changed from the current 19.5 cents per $100 of domestic deposits to 23 cents per $100 on July 1, 1991.

All scenarios require that the FDIC borrow for working capital purposes during this period, as it has in the past. We currently have about $70 billion in borrowing authority -- nine times our present net worth. Under the baseline scenario, failed-bank assets in 1991 are expected to be about $65 billion, not including banks failing in 1991 for which the FDIC recognized losses in 1990. The FDIC's net loss in these institutions is expected to be about $9.2 billion, but the initial outlay, which includes the loss, is likely to be about $19.1 billion, because of the likely need for the FDIC to fund the purchase of some of the assets of the failed banks. Similarly, in 1992, failed-bank assets under the baseline scenario are expected to be roughly $30 billion, corresponding to an insurance loss of $5.7 billion and an outlay of $15.7 billion. (See Attachment 1 for assumptions underlying these projections.)

Under the more pessimistic scenario, failed-bank assets in 1991 are expected to be about $90 billion, for a loss of $13 billion and an outlay in 1991 of $23.8 billion. The corresponding estimates for 1992 are failed-bank assets of $70 billion, an insurance loss of $10 billion and an outlay of $35 billion. The $35 billion 1992 outlay includes outlays for banks for which the FDIC recognized losses in 1991.

The FDIC must make other outlays in 1991 as well, including $8 billion for banks failing in 1991 whose estimated cost of failure was recognized in 1990, and $2.5 billion for note repayments and various operating disbursements. Total outlays for 1991 are $29.6 billion under the baseline scenario and $34.3 billion under the pessimistic scenario. For 1992, outlays under the two scenarios are $17.2 billion and $36.4 billion, respectively.

Three main conclusions emerge. First, the FDIC must borrow for working capital purposes. Cash and equivalents on hand at year-end 1990 of $6.9 billion, plus expected cash receipts during 1991 of $10.7 billion, fall considerably short of the outlay that will be required under either scenario. New borrowings required under the baseline scenario in 1991 will be $14.5 billion, and $19.1 billion under the pessimistic scenario.

Second, the FDIC will be able to borrow enough under either scenario to meet its needs for fiscal 1991. In fact, under the baseline scenario the FDIC will need no new borrowing authority for 1991 and 1992. Under the pessimistic scenario, however, the FDIC may need expanded borrowing authority late in 1991 and will certainly need substantial new borrowing authority in 1992.

Finally, and most important, a sound long-term plan to recapitalize the BIF is necessary. Adequate funding is essential for the insurer to operate in a cost-effective and decisive manner.

RECAPITALIZATION AND PROTECTING THE INSURANCE FUND

There is general agreement with regard to the guiding principles for any recapitalization plan. These are:

- Under present circumstances, the banking industry should be responsible for whatever losses are to be absorbed by the BIF.
- Recapitalization of the BIF addresses the immediate problems of the industry's insurance fund, but does nothing to address the more significant structural problems of the industry that have contributed to the present problems. That is, funding current problems needs to be accompanied by a restructuring of the banking system and additional safeguards for the protection of the insurance fund.
- The plan should not inhibit the industry from providing for the legitimate credit and liquidity needs of the local and national economies.
- The plan must be flexible enough so that the demands on the industry will be commensurate with the needs of the fund.
- Supervisory powers and regulations must be strengthened to reduce insurance fund losses.

These principles guided the FDIC in formulating our recommendations on the necessary components for a safe and sound deposit insurance fund.

Near-term Funding

As stated above, we believe the FDIC will need no new borrowing authority in 1991 and 1992 under the baseline scenario. Under our pessimistic scenario the FDIC can meet its financial requirements at least through fiscal year 1991, ending on September 30, and perhaps through the end of calendar year 1991. As indicated in Attachment 3, under this scenario, the FDIC may have to utilize the current $5 billion Treasury line of credit during fourth quarter 1991.

It is anticipated that the source of most FDIC borrowings for working capital will be the Federal Financing Bank (FFB). FFB borrowings mature on the first business day of the first quarter following the borrowing date, but both principal and interest can be "rolled over." The interest rate for FFB borrowings is one eighth of one percent above the three-month Treasury bill rate for new issues. The FDIC would pay this interest as it accrues, and would pay down the principal over a period not to exceed fifteen years. FFB borrowings by the FDIC are backed by the full faith and credit of the U.S. government, since both the principal balance and maturity are stated as part of the borrowing agreement.

To the extent that working capital is needed and borrowed in anticipation of losses, it will be repaid from dedicated increases in premiums.

The insurance losses in failed banks in 1991 will be paid for out of the current BIF fund, with borrowings being used to fund the purchase of assets from the failed bank at their estimated true economic value, as described earlier. For example, if the FDIC were required to borrow $18 billion in 1991, it would also have funded the purchase of non-liquid assets from failed banks estimated to be worth $18 billion. In addition, as an added cushion, a stream of additional premium income estimated to be worth $10 billion also stands behind any borrowings.

Since the FDIC could become insolvent, as it would in 1992 under our pessimistic scenario, or if the fund balance becomes insufficient to support necessary borrowings, a longer-term plan is required. Such a plan is described in the next section.

Some observers have expressed concern that the FDIC's proposed 3.5 basis point increase of the insurance assessment to finance borrowings will be substantially detrimental to the banking industry. While it will certainly not be beneficial, it can be borne by the industry without undue damage. The FDIC staff estimates that increasing the assessment rate from 19.5 cents to 23 cents for the second half of 1991 would have a minimal impact on industry capital levels. The tangible equity capitalization of BIF members as of September 30, 1990 was approximately $224.3 billion. An assessment rate increase of 3.5 basis points, effective with the second-half 1991 semiannual assessment, would raise 1991 industry assessments by an estimated $435 million during 1991, or less than .2 percent of third-quarter 1990 industry capital. On an annualized basis, the additional assessments ($870 million) amount to about .39 percent of third-quarter 1990 industry capital.

Insurance assessments are a tax deductible operating expense for banks. Assuming an average tax rate of 34 percent, the after-tax cost of the assessment increase would be $574 million per year. In addition, it is reasonable to expect that some portion of the assessment increase will be passed along to bank customers in the form of higher borrowing rates, increased service fees, and lower deposit rates. However, the FDIC staff has assumed, for the purposes of this analysis, that banks will bear the full after-tax cost of the assessment.

During 1992, the assessment increase is projected to raise the number of banks with less than three percent tangible capital by only six banks with average assets of under $34 million. The number of banks with between three and six percent tangible capital is projected to increase by nine with average assets of under $255 million. In sum, while the assessment increase lowers the book capital of most banks, the overall impact is expected to be negligible.

Longer-term Recapitalization and Funding Issues

In addition to meeting the BIF's current needs for liquidity, it is necessary to ensure the longer-term viability of the insurance funds. This involves the reforms to the deposit insurance system and the financial supervisory structure that currently are under debate, and additional flexibility to meet potential costs after 1991.

The Treasury Department has proposed in H.R. 1505, a longer-term funding plan for the BIF that requires the banking industry to fund certain obligations of the BIF -- no taxpayer money is requested. The FDIC Board has reviewed the main outlines of Treasury's recommendations to recapitalize the BIF and endorses the proposal.

The Treasury's long-term plan is a contingency plan. It is based on a total of $70 billion in standby borrowing authority. Of this, $45 billion would be for working capital to purchase non-liquid assets (such as real estate) from failed banks at their estimated true economic value, to be recovered over time as these assets are sold. The remaining $25 billion would be to absorb insurance losses, and would be repaid by the banking industry through dedicated insurance premiums.

The BIF has a $5 billion line of credit at the U.S. Treasury. The Treasury's proposal would authorize the BIF to use that line of credit as a base to borrow up to nine times that amount; under current law the BIF can borrow up to nine times its net worth. Therefore the Treasury proposal would result in the ability to borrow up to $45 billion. This borrowing authority would be used to provide needed liquidity. As discussed above, under a pessimistic (but not worst-case) scenario, the BIF's liquidity needs could amount to $19.1 billion for 1991; total borrowings under this scenario would reach $40 billion by year-end 1992.

The Treasury also has recommended that the BIF be given the authority to borrow up to $25 billion from the Federal Reserve. This borrowing authority would be used to cover insurance losses as required. Thus, this plan does not require banks to cover the losses in the fund immediately since such additional costs could delay the recovery of the industry. Instead, the BIF could borrow from the Federal Reserve or other sources and increase insurance premiums in order to repay the borrowing over time as the economy recovers.

The three principal merits of the proposal deserve emphasis. First, the plan provides adequate resources to deal with the most pessimistic scenario considered through 1993, based on the OMB scenario. As indicated in Attachment 2, under the OMB scenario, insurance losses from 1991 through 1993 could be as high as $36 billion. In conjunction with the BIF's year-end 1990 balance of $8 billion, and projected assessment income from 1991 through 1993 of $17 billion, the $25 billion in borrowing authority would provide $50 billion to cover the $36 billion insurance losses estimated by OMB. The $14 billion difference is a comfortable but not excessive cushion.

Second, the plan does not impose needless burdens. Money will not be borrowed unless needed.

Finally, and most important, the plan does not require taxpayer funding. For each $10 billion of borrowing up to the $25 billion authorization, 3.5 basis points of banks' insurance assessments would be dedicated to service principal and interest. The FDIC has already proposed an assessment increase that would cover up to $10 billion under this authority, so at most there would be an additional $15 billion in borrowings and an additional 5.25 basis points of insurance assessments dedicated to debt service. Even if it is necessary to raise insurance assessments this is consistent with the 30 basis point cap on aggregate assessments the FDIC has proposed.

The BIF's borrowings from the Federal Reserve Banks would be backed by the full faith and credit of the U.S. government, provided the maturity and principal amount are stated as part of the terms of the borrowing agreement. This should allow the BIF to borrow at the same interest rate as prevails for Treasury obligations of comparable maturity.

Another key part of the proposal would cap annual premiums paid by BIF-insured institutions at 30 basis points of the assessment base. This recommendation recognizes that the unlimited call on the banking industry's capital that now exists likely will deter capital from entering the banking industry. Any changes that are made to ensure adequate long-term funding for the BIF must be consistent with the need to maintain incentives for capital investment in the banking industry. However, in order to accommodate a system of risk-based insurance premiums, the FDIC should have the flexibility to charge particular institutions premiums that exceed the cap.

In our view, this plan is a sound and responsible way to ensure that resources are available to deal with any likely scenario. It provides a dedicated stream of income for repaying borrowings, and is based on the premise that funds will be borrowed only as they are needed.

While adequate funding for BIF is important, it is essential to take steps to promote the long-term viability of the insurance funds. Otherwise, we will just be pumping water out of a leaky ship. Funding current problems needs to be accompanied by a restructuring of the banking system and a strengthening of supervisory powers and regulations.

Reform requires recognition of the many interrelationships among industry structure, the deposit insurance system, and regulatory responsibilities. Reform of the deposit insurance system must include reform of the antiquated legal structure burdening the financial industry in general and the banking industry in particular. A healthy deposit insurance system depends ultimately on the existence of a healthy banking system.

In crafting reform legislation, it is vital to consider the short-term, as well as the long-term, impact of any given policy decision. Currently, there is no shortage of bad news as it relates to banking developments. There are regional liquidity problems, and depositors are uneasy. Our economy is experiencing strains on many fronts. Thus, we must seek long-term solutions that do not cause additional problems in the short term.

To halt the deterioration in the health of the U.S. banking system, broad structural reform of the industry is necessary as well. The Treasury Department's proposed legislation contains a thoughtful and comprehensive approach to structural reform. Although some differences remain, the FDIC generally supports the thrust of the Treasury's proposed legislation.

LAYING THE FOUNDATION FOR A SOUND DEPOSIT INSURANCE SYSTEM: RESTRUCTURING THE BANKING SYSTEM

The competitive environment in which banks operate is changing significantly. There are three noteworthy and interrelated trends: banking is becoming a riskier, more volatile business; banks are encountering greater degrees of competition; and what constitutes the business of banking itself is undergoing a rapid evolution. Banks and other financial institutions have been hampered in their ability to adjust to these changes by an antiquated legal structure.

Structural reform should begin by identifying and examining the underlying obstacles to a competitive and viable banking industry. These obstacles are:

1. Geographic barriers to bank expansion in the McFadden Act and the Douglas Amendment;

2. The product limitations of the Glass-Steagall Act; and

3. The ownership and product limitations of the Bank Holding Company Act.

Substantial benefits would result from eliminating the current ownership and activity restrictions imposed by these laws, so long as there are restrictions on the use of insured funds to support uninsured activities. Risks could be diversified. Significant new sources of capital would be available to the industry. Legitimate cross-marketing activities could enhance the profitability of the overall organization.

Interstate banking restrictions have contributed to the increased risk in the nation's banking industry and to the decrease in banks' competitiveness. Removal of these restrictions would permit lower risk through geographic diversification of lending. Banks also would be able to expand their operations to match the expansion of banking markets created by technology and economic growth. These archaic geographic restrictions will become even more unpalatable in the near future as the European Community eliminates restrictions on branch banking.

Geographic Restrictions

The FDIC supports the Treasury's recommendations for nationwide banking for bank holding companies and nationwide branching for banks. We believe nationwide banking and branching will allow the development of a more efficient banking system and will enhance the safety and soundness of the banking system as banks are allowed to hold a more geographically diversified portfolio of assets. We commend the interstate experiment that has been led by state authorities in recent years. Once again, the value of the dual banking system in fostering innovation has proven itself. It is now time to create some national consistency.

However, we realize there is controversy surrounding the elimination of interstate branching restrictions. If so, a less desirable, but possible, alternative that addresses states' rights and the dual banking system would be to remove only the barriers to interstate ownership of separately chartered banks while retaining the states' ability to limit interstate and intrastate branching or adopt the Wilmarth proposal put forward by the Conference of State Bank Supervisors. It is our view that this less-extensive alternate type of national banking could still achieve most of the savings ascribed to branching if the states' tax revenues are unaffected by these provisions.

Affiliation Authority

The FDIC agrees with the Treasury approach that banks should be permitted to affiliate with both financial and nonfinancial firms, provided certain requirements are satisfied. These requirements are that the bank should be well-capitalized upon completion of any affiliation transaction, and that supervisors are satisfied that the resulting entity will not operate in a manner abusive to the bank. For example, supervisory concerns about the character or competence of management of either the bank or the potential affiliate should be sufficient grounds to deny affiliation.

The primary benefit of expanded affiliation is that it will potentially provide new sources of capital to banking organizations. In addition, expanding the permissible range of affiliation for banking organizations will allow them to compete on a more equitable basis with other financial firms. The ultimate goal of any efforts at deposit insurance reform and industry restructuring should be to place banks on a safer and sounder financial footing over the long run. Allowing banks to affiliate with diversified financial and nonfinancial companies -- as the Treasury bill would do -- would contribute to that goal.

Legal and Economic Separation

One of the best ways to attack the problem of a generally riskier banking business is to limit the types of activities that can be supported with insured deposits. In other words, what can be done inside a bank should be restricted. If a banking organization wants to engage in riskier activities, it should do so only in nonbanking affiliates that are adequately separated -- both legally and financially -- from the bank. Capital flows between the bank and its affiliates or subsidiaries must be strictly limited.

An expansion of holding company activities must be accompanied by clearly articulated limits on the use of bank funds to support a holding company's operations. The general principle should be that all advances of bank funds should be governed by an "arm's length" requirement. Because it is often impossible to determine in practice that a particular transaction is not at arm's length, financial firewalls should be placed on transactions between banks and their nonbank affiliates.

The Treasury proposal would continue to subject banks and their affiliates to the interaffiliate lending and other restrictions of sections 23A and 23B of the Federal Reserve Act. The Treasury bill also would apply the section 23A restrictions to other types of affiliate transactions.

In the process of strengthening section 23A in this manner, it may be difficult as a practical matter to collateralize certain transactions, such as tax-sharing arrangements. It may be more reasonable to focus instead on loans-to-one-borrower requirements. We recommend that loans to all affiliates be aggregated for the purpose of determining whether an institution is in compliance with the restrictions of loans-to-one-borrower.

The FDIC generally supports the Treasury's recommendations with respect to funding firewalls between a bank and its nonbank affiliates, but recommends certain additional protections for the insured bank. In particular, section 23A restrictions should be expanded to include bank funding which -- although not extended directly to an affiliate -- is of benefit to an affiliate. For example, funding for a customer or supplier of an affiliate which is used in connection with the customer's or supplier's transactions with the affiliate should be restricted.

The Treasury believes that stronger firewalls are necessary between banks and their commercial affiliates than between banks and their nonbank financial affiliates. The FDIC believes that transactions with financial affiliates can be just as abusive as those with commercial affiliates, and that different types of firewalls based on the identity of the nonbank affiliate are inappropriate. The question of what constitutes appropriate firewalls should not be confused with the issues relating to bank ownership. Instead, the adequacy and appropriateness of each firewall should be determined on its own merits, and the same firewalls should apply to transactions between insured banks and all their nonbank affiliates.

Umbrella Oversight

Umbrella oversight is a phrase that summarizes the powers Treasury recommends that bank supervisors should have over nonbank affiliates of banks and their holding companies, separate and apart from the funding and disclosure firewalls discussed above. The FDIC agrees that bank supervisors should continue to have the discretion to examine and obtain information from nonbank affiliates. The FDIC disagrees, however, with the imposition of mandatory "trigger points" that would require bank supervisors to force the divestiture of a nonbank affiliate or apply bank capital and other holding company standards to the entire organization on a consolidated basis. It is not clear that supervision of the holding company is an easier or more effective way to protect the bank than an attempt to enforce firewalls. Holding company supervision discourages capital investment in holding companies and prevents these organizations from adapting effectively to technological and market changes. Reliance on objective rules governing permissible transactions would be effective in preventing inappropriate use of bank funds.

Source of Strength

The capitalization provisions contained in the Treasury's proposed legislation -- notably those subjecting owners of "Zone 3" banks to consolidated capital requirements unless they recapitalize or divest the bank in question -- raise a number of concerns and questions. Legislatively mandating that holding companies act as a "source of strength" to their affiliated organizations could undermine the goals of limited corporate liability envisioned by having separate bank affiliates.

If such ownership burdens are mandated by Congress, they would make investments in bank equities unattractive. Right now, particularly, we need to encourage investment in banks, not discourage it. Many bank stocks prior to the mid-1930s were subject to additional assessments if a bank experienced financial difficulties. Congress and the state legislatures removed these requirements because of their negative effect on the ability of banks to raise new capital.

Functional Regulation

The FDIC believes that holding company affiliates should be regulated along functional lines, with supervisory attention focused on the safety of the insured bank and the enforcement of strong firewalls between banks and their nonbank affiliates. The Treasury proposal endorses these goals. However, we are concerned that the financial services holding company (FSHC) structure mandated by the Treasury bill would introduce a new and unnecessary layer of holding company regulation.

While Treasury's plan removes restrictions regarding affiliations of well-capitalized banks with financial firms, the FSHC structure maintains an artificial distinction between financial and other forms of commerce. In the FDIC's view, as long as firewalls are sufficient to protect the insured bank, owners of banks -- corporate or financial -- should be accorded the same rights and regulated in the same manner. To the extent that corporate owners are treated differently under the FSHC structure, through the umbrella oversight of the bank regulator or the application of different firewalls, it results in multiple layers of regulation that discourage investment in banking organizations.

The FDIC believes, moreover, that it is not necessary to dictate the corporate structure of banking organizations as long as safeguards are in place to protect the insured entity. The same principles of regulation and protection of the insured bank should apply whether the nonbank ownership relationship is through affiliates under a holding company arrangement or through separately capitalized subsidiaries of the insured bank.

BUILDING A SOUND DEPOSIT INSURANCE SYSTEM

In addition to removing existing obstacles to a viable and competitive banking industry, deposit insurance reform must be tackled. The objectives of reform should be to maintain the stability of the financial system, to reduce the potential liability of the government for its safety net and to ensure that the banking industry bears the appropriate costs of insurance.

Any system of supervisory controls creates costs and benefits. The issue sometimes comes to the fore only when changes in the supervisory system are considered, or when a disaster such as the savings-and-loan crisis sheds light on the costs and benefits. Changes in the deposit insurance system, and the bank supervisory structure in general, will entail shifts in costs and benefits.

Reducing the Scope of the Safety Net

"Too-Big-to-Fail" and the Resolution of Failed Banks. In some cases, it may be necessary to have the flexibility to resolve the failure of a large troubled bank in a manner which protects all depositors. The need for this flexibility arises because of macroeconomic considerations that are much broader than those pertaining specifically to deposit insurance.

In many other countries, the central bank or the counterpart of the Treasury has the responsibility both for determining when this flexibility should be used and to pay the associated costs. In the United States, those responsibilities have rested with the FDIC. Many of the current deposit insurance reform proposals seek to change this.

The Treasury proposal provides that the decision that a bank is "too-big-to-fail" should be made by the government agencies charged with maintaining macroeconomic stability, and not by the FDIC. However, it requires the FDIC to bear the costs associated with protecting the uninsured creditors in these situations.

The FDIC believes that decisions on "too-big-to-fail" should be dealt with on a public-policy basis. Funding for "too-big-to-fail" should come from the U.S. Treasury through a special fund set up for that purpose. Because these decisions must be made within hours, the creation of a stand-by fund is essential. There simply is no time to go to Congress for an appropriation. If, as we suggest, Treasury pays for "too-big-to-fail," then the decision-making authority should rest with it as well, in consultation with the Federal Reserve Board and the FDIC. If Congress instead decides that the insurance fund should pay for "too-big-to-fail," any decision to use it should be made by the FDIC with the concurrence of the Federal Reserve Board and the Treasury.

If the insurance fund must bear these costs, then it is necessary that the FDIC have the authority to adjust the assessment base as may be appropriate. These costs, by the way, are not as great as one might think. Over the past five years, the FDIC has determined that four banks were "too-big-to-fail" and protected all depositors. The cost of protecting the uninsured depositors of these institutions was less than a billion dollars or 3.5 percent of the FDIC's total insurance losses over this time period.

If Congress makes the decision to eliminate "too-big-to-fail," a great deal of potential disruption can occur. Resolution methods are needed that can sort out the various insured and uninsured claims swiftly and accurately. This may require a "final settlement" arrangement similar to that proposed in the American Bankers Association's study of deposit insurance reform and contained in the Treasury's proposal. However, it must be recognized that this type of approach would require that the larger banks maintain systems capable of differentiating between insured and uninsured claims on a real-time basis.

The Treasury bill requires the FDIC to pursue the least-cost method for resolving failed banks. We agree that the least-cost method is desirable. The least-cost method will require a comparison between liquidation costs or an insured-deposit transfer, and the proposed acquisition transaction. In determining least-cost, however, the viability of the purchaser must be a consideration. Thus, the management, capital position, and profitability of the purchaser, both before and after any acquisition, must be relevant factors in any determination.

Liabilities. One approach to shrinking the safety net is to restrict the coverage of bank deposits and other liabilities. Given the rather fragile economic circumstances of the moment, caution is certainly in order and any reduction in coverage probably should be phased-in gradually. With this proviso, aspects of the Treasury proposal appear most promising.

The first is the proposed reduction in the number of separate insurance capacities that individuals may use to insure funds. For example, we generally support limiting insurance coverage to $100,000 per individual per institution -- as the Treasury proposal would do. We also favor an additional $100,000 per individual per institution for certain retirement funds -- as the Treasury bill provides. Under current law, the FDIC insures deposit accounts according to the "rights and capacities" in which they are held, such as individually owned, joint, or trust accounts. Deposits maintained in different rights and capacities are separately insured up to $100,000 each.

The rules for separate coverage for certain types of accounts could be simplified without risking major instability and without impairing the smooth operation of failure resolutions. Additionally, and in accordance with the Treasury proposal, the FDIC recommends that separate insurance be maintained for certain agency, custodial, nominee, and conservator accounts (such as real-estate escrow accounts and attorney trust accounts).

While streamlining deposit insurance coverage may have some benefits in terms of shrinking the safety net, we do not know what the full effects will be. We expect there will be some disruption during a phase-out of coverage, and any negative effects on public confidence must be weighed against changes to coverage that may have no meaningful reduction in risk to the fund.

There are specific provisions in the Treasury bill to restrict so-called "pass-through" insurance coverage for pension plans. The FDIC recognizes that pass-through coverage for large pension plans has been used by aggressive market participants to make use of the deposit insurance guarantee fully and to expand the federal safety net. Over the long term, this expansion of the net might be safely retracted by removing pass-through coverage from most pension plans.

The longer-term goal of the Treasury bill to impose a limit on deposit insurance coverage of $100,000 per individual systemwide is more problematic. It would benefit large banks at the expense of small banks (given that only large banks are likely to qualify for the "systemic risk exception" contemplated by Treasury), create more instability in the banking system, and greatly increase the administrative costs associated with deposit insurance. To make this a long-term goal at this point will have very negative effects on depositor confidence in the banking system. While the goal of depositor discipline is presumably to channel funds away from poorly run institutions and toward well-run institutions, the likely result of limiting depositors to a single insured account would be to channel funds away from all banks save the largest. We believe the advisability of such a broad-brush approach to reducing coverage should await the results of more gradual changes suggested here. Further study by the FDIC with a proposal on individual systemwide coverage, if necessary, can be made at a later date.

Finally, we understand that the Committee is concerned about aspects of the Treasury's proposal that would expand the use of taxpayer identification numbers for registering insured deposits. A brief description of how the FDIC currently recognizes insured deposits may be helpful. As mentioned above, deposits are insured according to the "rights and capacities" in which they are held.

We currently rely upon the insured depository institution's records when determining the amount of insurance available to a depositor. The FDIC presumes that funds are owned as shown on the "deposit account records" of the institution. If we determine that the deposit account records of the institution are unambiguous, those records are binding on the depositor. No other records are considered in determining legal ownership. "Deposit account records" are account ledgers, signature cards, CDs, passbooks, and certain computer records. The FDIC does not rely on taxpayer identification numbers in determining deposit insurance coverage. Insurance is based upon actual ownership of the deposit funds, and tax identification numbers are not necessarily conclusive as to ownership.

REGULATORY RESTRUCTURING

In addition to reforms concerning banking industry structure and the deposit insurance system, the difficult task of improving the rationality and efficiency of the regulatory structure must be addressed. That structure currently consists of three federal bank regulators, one thrift regulator, one federal credit union regulator, and a variety of regulators in the 50 states. Responsibilities are often overlapping and redundant. The concept of functional regulation takes second place to the concept of institutional regulation.

Although the elimination of many of the outdated aspects of the current structure would appear to be possible, there should be no regulatory restructuring merely for the sake of restructuring. Any changes to the regulatory system ultimately should promote greater efficiency and eliminate unnecessary duplication. However, any changes in the regulatory structure will entail substantial disruptions with the attendant uncertainty, morale problems and things "slipping through the cracks" during the transition. Given the current strains affecting the banking community, changes in the regulatory structure should be implemented only if there are significant gains to be achieved that clearly outweigh the disruption and uncertainty that would be involved.

Several principles should guide any efforts to improve the regulatory structure. First, and most important, experience indicates that the independence of financial regulators and insurers is essential to supervising the financial system. The insurer should be independent and permitted to operate, to the extent possible, like a private insurance company.

Second, banking supervisors should not be subject to conflicts that may arise if they are responsible for other important functions and objectives, such as monetary policy, international economic stability, and revenue production.

Third, the regulatory structure should be simplified.

Fourth, any new structure should provide a forum where decisions can be reached binding all regulators to uniform rules. One of the goals of reform efforts must be to eliminate potential turf battles and to allow for greater uniformity in decision-making.

Last, but not least, the dual banking system should be preserved. This system, which has served our country well by fostering financial innovation, should not be a casualty of efforts to realign regulatory responsibilities.

Under the regulatory restructuring plan put forth by the Treasury Department, the OTS and OCC would be abolished. A new federal banking agency, the Office of Depository Institutions Supervision, would be established within the Treasury Department to supervise national banks, all thrifts, and their holding companies. The Federal Reserve Board would supervise all state-chartered banks and their holding companies. The FDIC would no longer have a direct regulatory or supervisory role. However, the FDIC would retain its ability to examine institutions applying for insurance and to conduct special examinations of any insured institution for insurance purposes.

The Treasury proposal conflicts with some of the principles that should guide regulatory restructuring. It is essential that primary supervisory authority for insured institutions should reside with an independent agency and be shielded from direct political influence. The Comptroller General of the GAO has expressed the same view recently in separate testimony before the Congress. In addition, dividing national and state banks between two regulators but putting all savings associations under the national bank regulator is an inconsistent recognition of the dual banking system.

Other provisions in the Treasury plan also could compromise regulatory independence. We strongly object to the provision that would require that litigation by the federal bank regulatory agencies be subject to the Attorney General's prior consent and control. Such a requirement would infringe upon the agencies' independence and could have severe consequences upon the agencies' ability to recover losses.

The Treasury's proposal would remove the FDIC as the primary federal regulator of state nonmember banks. We believe that the important issue is not necessarily who is primary federal regulator but that the FDIC have back-up examination and enforcement authority over all insured depository institutions including state nonmember banks. Under today's rules for state nonmember banks, the FDIC essentially is the back-up regulator to state regulatory authorities. Thus, providing the FDIC with back-up regulatory authority over all insured institutions is consistent with the position we hold today to state nonmember banks.

Furthermore, we believe that certain minimum standards must be specified to ensure the deposit insurance system's independence and viability. These standards are as follows:

First, the federal deposit insurer must be able to act vigorously and independently, in a manner analogous to private insurance companies, to protect its funds and the taxpayers against losses. The insurer should be an independent agency with a Board structure that encourages the exercise of this independence. All primary federal regulators should be represented on the Board but they should constitute less than a majority of the Board. In addition, staggered terms for Board members would ensure continuity and stability.

The insurer should participate in the process of monitoring insured institutions' risk exposure to ensure that they remain financially strong. The insurer must have an experienced examination and supervisory staff and be a back-up regulator for all insured institutions. Under the Treasury's proposal the FDIC would retain back-up enforcement authority over thrifts, but would not be given this authority over insured banks. Further, the insurer should be able to set minimum capital standards for any bank it insures.

Federal deposit insurance with respect to all institutions should be granted only with the approval of the insurer. The insurer should have the right to deny insurance based on the specific statutory criteria currently provided for in section 6 of the FDI Act. The decision of the primary regulator to issue a charter may be presumptive evidence of the institution's insurability, but such presumption should be rebuttable by the insurer's Board if it determines the institution does not meet the criteria.

Revoking insurance promptly is as important as determining who gets insurance in the first instance. The insurer must continue to be able to terminate insurance expeditiously for institutions it determines to be operating in an unsafe and unsound manner.

The insurer must continue to have insurance premium setting authority. Such authority provides the insurer with broad discretion to set generally applicable prices for insurance, including prices based on risk.

As mentioned earlier, the insurer also should have authority to determine that any specific activity poses a serious threat to the SAIF or BIF, and to prohibit insured institutions from engaging in such activities. This is the same authority that FIRREA provided to the FDIC for SAIF members.

Thank you Mr. Chairman -- this concludes our statement.

Attachment 1

Assumptions for Bank Insurance Fund Projections*

1. The assessment rate increases to 23¢ per $100 of domestic deposits beginning June 30, 1991 and remains at that level through year-end 1992.

2. The estimated number of bank failures is based on projections by the FDIC's supervisory staff.

3. Cash outlays:
    - Banks under $100 million, 60% of assets
    - Banks between $100 million and $1 billion, 50% of assets
    - Banks over $1 billion, 30% of assets

4. Bank failure costs:
    - 29% of assets for banks under $100 million
    - 18.1% of assets for banks between $100 million and $1 billion in assets
    - 13-25% average for banks $1.0 billion and over

5. Liquidation proceeds**:

    The net present value of failed bank assets retained by FDIC is recovered over a 5 year period as follows:

    17.5% in 1st year, 30% in 2nd year, 22.5%, 15% and 15% in 3rd, 4th and 5th years.

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* Estimates of cash outlays, bank failure costs and liquidation proceeds are based on historical experience.

** The figure for recoveries in the first year reflects that, on average, failed bank assets are held by the FDIC for only one-half of the calendar year during which the bank is closed.

Attachment 1

BANK INSURANCE FUND TRENDS AND PROJECTIONS, 1984 - 1992

				Baseline Estimate				Pessimistic Estimate			
Year	Number of failed banks	Failed bank assets ($Bill)	Adjusted failed bank assets[1] ($Bill)	Total revenue[2] ($Bill)	Total expenses ($Bill)	Fund balance ($Bill)	BIF reserve ratio	Total revenue[2] ($Bill)	Total expenses ($Bill)	Fund balance ($Bill)	BIF reserve ratio
1984	80	$38.9	$38.9	$3.1	$2.0	$16.5	1.19%	$3.1	$2.0	$16.5	1.19%
1985	120	8.8	8.8	3.4	2.0	18.0	1.19	3.4	2.0	18.0	1.19
1986	145	7.7	8.9	3.3	3.0	18.3	1.12	3.3	3.0	18.3	1.12
1987	203	9.5	20.8	3.3	3.3	18.3	1.10	3.3	3.3	18.3	1.10
1988	221	53.9	61.6	3.4	7.6	14.1	0.80	3.4	7.6	14.1	0.80
1989	207	29.2	15.5	3.5	4.3	13.2	0.70	3.5	4.3	13.2	0.70
1990[3]	169	16.3	39.8	3.9	8.7	8.4	0.42	3.9	8.7	8.4	0.42
Estimates for 1991 and 1992:											
1991	180 - 230		$65 - 90	$5.7	$10.0	$4.1	0.20%	$5.7	$13.9	$0.2	0.01%
1992	160 - 210		30 - 70	6.0	6.5	3.6	0.17	6.0	10.8	−4.6	−0.22

1. Reserves are established for open banks when their failure appears likely. The adjusted figures on failed bank assets reflect either the year reserves were established or the year the bank was actually closed, whichever was earlier.

2. Assumes that the assessment rate increases to 23¢ per $100 of domestic deposits by mid-year 1991 and remains in effect through year-end 1992.

3. 1990 BIF revenue and expense figures are preliminary.

Attachment 1

BIF Liquidity Analysis

(Potential Borrowing Needs in Billions of Dollars)

	Baseline Estimate			Pessimistic Estimate		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*
Projected Bank Failures	169	180	160	169	230	210
Cash Receipts	$ 6.9	$ 10.7	$ 14.4	$ 6.9	$ 10.8	$ 16.8
Cash Outlays	13.8	29.6	17.1	13.8	34.3	36.4
Net Cash Position for Year	(6.9)	(18.9)	(2.7)	(6.9)	(23.5)	(19.6)
Beginning Cash	13.8	6.9	2.5	13.8	6.9	2.5
Ending Cash ($2.5 Billion Minimum)	6.9	2.5	2.5	6.9	2.5	2.5
New Borrowings	-	14.5	2.6	-	19.1	19.6
Outstanding New Financing	-	14.5	17.1	-	19.1	38.7
Scheduled Notes Outstanding	2.6	1.5	1.3	2.6	1.5	1.3
Total Debt Outstanding	2.6	16.0	18.4	2.6	20.6	40.0

PROBLEM BANK CHANGES, 1984-1990

	All Commercial Banks	Problem Commercial and Savings Banks[2]				
Year	Problem asset ratio[1]	Number of problem banks	Number of banks added	Number of banks deleted	Total problem bank assets ($Bill)	CAEL additions (# of banks)[3]
1984	1.97%	848	502	296	$228.3	
1985	1.87	1,140	604	312	237.8	
1986	1.95	1,484	838	494	335.5	515
1987	2.46	1,575	718	627	358.5	361
1988	2.14	1,406	511	680	352.2	296
1989	2.26	1,109	322	619	235.5	224
1990	2.92	1,046	382	445	408.8	243

1. Calculated by adding loans past due 90+ days *plus* nonaccrual loans *plus* other real estate owned *divided* by total assets. Excludes BIF-insured savings banks.

2. This schedule summarizes changes in the problem bank list over the last several calendar years. While the volume of assets held by problem banks is worthwhile information, the risks to the Fund and the likelihood of actual failures of problem banks varies enormously between individual institutions. Moreover, the addition or deletion of large banks to the list limits the value of the total asset numbers, in and of themselves, as a barometer of the size of impending resolution costs.

3. Using call report data, the CAEL model simulates the bank examiner's decision process to assess the financial condition of a bank. CAEL's assessment produces an off-site equivalent of a CAMEL rating (excluding M, management). CAEL then compares its off-site rating to the rating assigned at the last examination. Differences between CAEL and the most recent CAMEL for individual banks are reviewed to help determine examination schedules and focus. In the aggregate, CAEL data usage is varied. As used above, CAEL data indicate the potential deterioration in banks rated "1" and "2" at their most recent examination. As of September, 1990, for example, 243 banks rated "1" or "2" at their last examination are now rated a weak "3", "4", or "5" by CAEL.

ATTACHMENT 2

Comparison of BIF Estimates

($ in billions)

	1991	1992	1993
Fund Net Worth			
OMB	4.4	(2.2)	(9.1)
CBO	1.4	(2.8)	(2.6)
FDIC - base	4.1	3.6	
FDIC - pessimistic	0.2	(4.6)	
Assets of Failed Banks			
OMB	62.4	62.4	62.4
CBO\1	96.6	66.9	44.6
FDIC - base	65.0	30.0	
FDIC - pessimistic	90.0	70.0	
Losses on Failed Banks			
OMB	12.0	12.0	12.0
CBO	13.0	9.0	6.0
FDIC - base	9.2	5.7	
FDIC - pessimistic	13.1	10.0	
Premium Assessments			
OMB	21.25	23	23
CBO	21.25	27	30
FDIC	23	23	
Deposit Base Growth			
OMB	3.9%	6.6	7.3%
CBO	4.5	4.5	4.5
FDIC	4.5	4.5	

ATTACHMENT 3

BANK INSURANCE FUND
PROJECTED STATEMENT OF OPERATIONS – 1991
(Dollars in Millions)

Pessimistic Estimate

	Net Income	Fund Balance	Capital Ratio	Maximum Obligations	Current Obligations	Available Borrowing	Cumul. Borow. Shortfall
December '90		8,356	51.2%	75,204	7,957	67,247	0
January	280	8,636	71.5%	77,720	3,444	74,276	0
February	89	8,724	66.8%	78,518	4,328	74,191	0
March	18	8,743	73.9%	78,683	3,091	75,592	0
April	(360)	8,383	78.2%	75,447	2,338	73,109	0
May	(755)	7,628	79.2%	68,648	2,004	66,643	0
June	(1,200)	6,428	75.8%	57,851	2,049	55,801	0
July	(969)	5,459	57.9%	49,134	3,967	45,167	0
August	(969)	4,491	35.8%	40,417	8,051	32,368	0
September	(1,287)	3,204	20.5%	28,833	12,399	16,434	0
October	(1,298)	1,906	10.1%	17,150	16,956	194	0
November	(930)	975	4.7%	8,777	19,658	0	2,702
December	(819)	156	0.7%	1,404	21,982	0	5,026
Total	(8,200)						

Mr. GIBBONS. Let me ask you—first of all, let me make an administrative announcement. The committee will take the next panel after this witness, and then the last panel will be postponed—will be heard at 2 o'clock. So those of you who are in the last panel, the American Bankers Association, National Council of Savings Institutions, et cetera, will be heard at 2 o'clock.

Let me ask you, what got the banks in this trouble?

Mr. BOVENZI. Careless lending in real estate. We looked at the large failures we have had in Texas and in other States, and we have seen excessive concentrations in commercial real estate. We have seen lending on raw land. We have seen lending with little or no money down.

We have seen the banking industry or parts of the banking industry move away from the more prudent lending standards that had been in place in the past. And that, probably more than anything, has contributed to the losses in the Bank Insurance Fund.

Mr. GIBBONS. Why did they get so imprudent in real estate?

Mr. BOVENZI. There were probably a lot of reasons combined, one being that the legal requirements were relaxed from 1974 through 1982. There was very strong competition that forced each institution to try to keep up with the others. There were weaknesses in regional economies which caused the institutions to look for ways to improve earnings to get out of other problems.

So it was a combination of events, I believe.

Mr. GIBBONS. Why should we put these imprudent people in the insurance business and in the real estate business now? Could you explain that to me? I have a hard time understanding that.

Mr. BOVENZI. I think our focus has to be on what is done with insured deposits, and the FDIC very much supports limiting what can be done with insured money. We don't want the credit of the U.S. Government getting into more and more activities.

I think the way the Treasury proposal is structured, it does that. It will not allow insured deposits to be used to fund insurance, real estate investment, securities activities, or other activities.

Mr. GIBBONS. But all those insured deposits can be used as loans to customers of those new institutions that these imprudent people are going to have. It is the same.

Mr. BOVENZI. There would be limits on the amount of loans you could have to any individuals, and each bank would be required to meet capital standards and would be subject to examination of all of its loans. So I would focus intensively on the bank itself, making sure it was operating in a safe and sound manner.

You would structure those firewalls between other activities so that if the other activities got into trouble, it would not affect the bank.

Mr. GIBBONS. If the bank has a real estate subsidiary, don't you think the bank is going to be interested in lending money to the customers of that subsidiary?

Mr. BOVENZI. I believe that the bank is interested in making creditworthy loans; some of those may be customers of the subsidiary. If there are limits on the amount of those loans, so they cannot absorb a large proportion of the bank's capital, then the bank itself is protected regardless of what happens to that subsidiary.

Mr. GIBBONS. Mr. Pickle.

Mr. PICKLE. Mr. Chairman.

Mr. Bovenzi, is the FDIC at this time delaying taking any action with respect to troubled banks because of a shortage of funds?

Mr. BOVENZI. No, sir. The FDIC is not delaying action due to any shortage of funds. We have sufficient borrowing authority right now to meet all of the requirements before us. And I have pointed out that we will need new authority as we approach the end of the year, so that we are not strapped for cash. But at the moment, we have the authorities we need and are taking the actions that come before us.

Mr. PICKLE. Your testimony is that you have got plenty of money now to take care of any problem with troubled banks, and you don't need any money, you are just looking ahead?

Mr. BOVENZI. I don't mean to minimize it. We are not taking inappropriate actions now based upon looking forward. We are trying to resolve every failed bank the most effective way possible. We will need a recapitalization.

Mr. PICKLE. Let me rephrase it.

Is your money close to being depleted, to take care of the banks at this point?

Mr. BOVENZI. At this point, we have $8 billion in the fund. About $6 billion of that is cash or other liquid assets that can be used to handle bank failures. We can leverage that for working capital purposes.

Mr. PICKLE. You say, you have got from $1 to $6 billion in the fund now?

Mr. BOVENZI. We have $8 billion net worth, $6 billion liquid cash and assets. Three years ago we had $18 billion in the fund.

Mr. PICKLE. So you are down now to less than a third of that?

Mr. BOVENZI. That is correct.

Mr. PICKLE. So there have been no delays and it is not costing the Government, but you need money, anticipating ahead; is that correct?

Mr. BOVENZI. Our expectations are that there will be a number of bank failures of a substantial size.

Mr. PICKLE. Does the FDIC have a preference of where you get the money?

Mr. BOVENZI. The actual source of the money is not a significant concern to us as much as the availability and cost of the money. Our understanding is that borrowing from the Federal Reserve or the Treasury would cost us the same, but either place is acceptable to us.

Mr. PICKLE. As Mr. Seidman has stated publicly, at least in the press and other speeches, that he didn't care where the money came from, but that as much as he wanted to be able to borrow it somewhere from somebody—which leads me to believe that he is not going to make a point of whether it is on budget or off budget or from the Treasury—obviously, the chief advantage for the taxpayer would be to put it on budget, direct from the Treasury.

Would you agree with that?

Mr. BOVENZI. We would find that quite acceptable if that is how it comes out. That would be fine, if we are able to borrow money from the Treasury.

Mr. PICKLE. That would be satisfactory to you? You don't have a preference, but that would be agreeable to you?

Mr. BOVENZI. That's right.

Mr. PICKLE. Now, you would borrow this $25 billion from the Federal Reserve, and you do it by raising your premiums up to 30 cents on 100; is that your recommendation?

Mr. BOVENZI. Yes.

What we have proposed is that—our premiums have been 19.5 cents per $100 of insured deposit. We have just raised that to 23 cents. That increase of 3.5 cents would be dedicated to pay back $10 billion of borrowing. So, for every $10 billion we borrowed, we would raise the premium 3.5 cents; that would allow us to go to a maximum of a 30-cent premium if we had to borrow the full amount, the $25 billion.

Mr. PICKLE. These figures you are using, is that from any study, or is that just your recommendation?

Mr. BOVENZI. The figure of 30 cents?

Mr. PICKLE. Yes.

Mr. BOVENZI. It is based on a couple of factors, one being the former cap was very close to that at 32.5 cents; the second being the maximum amount we calculated we would need to get to repay the maximum borrowings from the Federal Reserve.

Mr. PICKLE. If you did pass the 30-cent cap, how many years would it take for FDIC to pay back its money it has borrowed to the Federal Reserve on the 30-cent-level basis?

Mr. BOVENZI. If we had to borrow from the Federal Reserve, it would be repaid over a 15- to 20-year period.

Mr. PICKLE. A long time.

Mr. BOVENZI. Yes.

Mr. PICKLE. All right. Now, what about the assets? You are asking for $45 billion in working capital. I find it a little bit interesting that you want $25 and $45, up to $70 billion, and when I ask you how much you need for 1992 and 1993—Secretary Glauber said and you indicated almost the same figure, that for 1991, you would want—he said you would need $4.5, and 1992, you would need up to probably $9 billion. That is more than any money you have got now.

But those figures, I assume, are approximately what you estimate; is that correct?

Mr. BOVENZI. Those are the figures for what our net worth would be. We project that we could be $4.5 billion in the hole in 1992. We would need more than that in actual borrowings when you add on the liquidity.

Mr. PICKLE. This $45 billion is going to be repaid at working capital from the the sale of assets.

Do you think the sale of assets would bring in that amount of money?

Mr. BOVENZI. We would only borrow that amount of money if there were assets coming in from failed banks that had that estimated value. Our borrowings would be tied to the value of the assets that were supporting them.

So, yes, we would only be borrowing what could be paid back under this purpose.

Mr. **Pickle**. If you are only going to borrow only what will be paid back, do you think that amount of money will be sufficient?

Mr. **Bovenzi**. I believe so. Under all the projections that have been made, when you combine $45 billion for working capital and $25 billion for possible negative worth, that exceeds all of the projections made by every Government agency that has made such projections.

Mr. **Pickle**. The sale of assets under the savings and loan has gone very slowly. It is a complex matter. There is not a market out there. That is true in the Southwest, as well as the Northwest.

Now you are going to have not only assets of the savings and loan, but you are going to have assets to the bank. Wouldn't that make it twice as hard to sell assets? Isn't it twice as realistic to say now those assets won't be sold for the amount of money you estimate?

Mr. **Bovenzi**. No doubt it is a difficult market. These markets are going to have to be dealt with one way or another regardless of how the assets are financed.

It is going to reduce values. That has to be taken into account up front in estimating their economic value in determining what is appropriate to borrow.

The direction of your question, I believe, is getting at is it possible for conditions to change in such a way that you can't back up the $45 billion with the assets. That is always possible.

We would make an estimate of the value of those assets by taking into account how many are on the market. But if conditions continue to deteriorate, that estimate could change.

Mr. **Pickle**. All right.

If the conditions continue to deteriorate or the market remains very poor, then we have to say publicly that the sale of assets will not bring in enough money to pay it back, the premiums will probably not be as much and that the taxpayers will have to pay the difference. It is going to cost us, if it doesn't work out just as you hope. I am concerned about any of the approaches. I am not trying to be negative about the entire thing. I think realistically we better say whatever we borrow ought to be from Treasury.

Two, it ought to be subject to Federal debt limit.

Three, this 30 cents limitation is the 1st cap we have ever had. It is an arbitrary figure, that for sale of assets is not enough. That means it is going to cost the taxpayers, and we ought to have that understanding.

That is my main point, Mr. Chairman. Thank you very much.

Mr. **Gibbons**. Let me go back on that.

You in your testimony made the pessimistic analysis that the Bank Insurance Fund may be in deficit by $4.6 billion by the end of 1992. How would this deficit be funded?

Mr. **Bovenzi**. That is the amount that the banking industry would be obligated to repay over time through increased premium assessments.

Mr. **Gibbons**. In other words, the taxpayers would have to bail out the banks or lend the banks money over a period of time; is that right?

Mr. **Bovenzi**. That is right.

The premium increase we have proposed, we feel the banks can handle that and they can repay that.

Mr. GIBBONS. Taxpayers would have to lend them the rest of the money?

Mr. BOVENZI. The other money is borrowed for the working capital purposes that would be repaid from selling the assets that we took over. That component is not repaid by the banking industry, but is repaid from our collections on failed banking assets.

Mr. GIBBONS. That is what the taxpayers have to cough up?

Mr. BOVENZI. That would be the amount that would be lent. It would not be any taxpayer contributions.

Mr. GIBBONS. Well, I am not going to live forever, although I would like to, I guess. But the current taxpayers, the ones that all of us, like all of us, the ones who have limited lives, would have to put up some of their money to bail the banks out. Our grandchildren may get the benefit of interest that they pay back, but the rest of us are going to have to put up some money to bail them out; is that correct?

Mr. BOVENZI. No question, this would raise the Federal deficit, any borrowings that we had, because we would be borrowing from the public to cover these liquidity needs.

Mr. GIBBONS. Your testimony shows that increases the total problem bank assets in 1990.

Do you think we will continue to see these problems, problem assets continuing to rise over the next several years?

Mr. BOVENZI. The problem bank assets have continued to rise. I believe that it will have to turn around within a couple of years.

I think right now you are seeing banks across the entire country are quite aware of the effects of weak lending practices and of making bad loans. We are not now seeing great increases in the amount of new problem loans.

The situation is entirely dependent upon the direction of the economy. Those loans that are creating problems now are already on the books. They are either going to get stronger or they are going to get weaker, depending on which direction the economy goes in. That more than anything will determine the amount of assets on the problem list.

Mr. GIBBONS. Mr. McDermott, I apologize to you. I didn't see you down there.

Mr. MCDERMOTT. Mr. Chairman, I appreciate your line of questioning. I was just going to call to your attention, it says on page 6, that finally and most important, its plan does not require taxpayer funding. Obviously, the taxpayers are free and clear. No problem for them. That is reassuring to see that in the testimony.

But when I was a Ways and Means Committee chairman we used to do revenue estimates. The economic people would come in and give us the optimistic, and the baseline, and the pessimistic revenue estimates.

I want to really understand this. I have the feeling in the savings and loan thing, it is like getting on an airplane that is going to take off shortly. The flight attendant goes up the aisle pushing the drink cart. If you have been on more than one plane in your life, you know you are not going to take off shortly.

I have the feeling today if I understand you correctly, you are citing the administration's position that this recession is going to be over by May or June. You are coming in here asking for borrowing authority on a pessimistic outlook, that sounds like 440 more bank failures in the next 2 years. I would like to know what assumptions you have about when the recession is going to be over, what the bank interest rates are going to do, those kinds of things that go into belief that the recession will end soon.

I look through your information in the back of your testimony. There are no assumptions about what the economy is going to do that would lead to the conclusion that there will be large-scale bank failures.

You have given us all the Bank Insurance Fund assumptions.

I would like to know what you think the economy is going to do that is central to your proposition.

Mr. BOVENZI. Let me make a few comments about that. I don't know that we are necessarily contradicting any administration forecast rather than saying that you don't place 100-percent certainty in any forecast, any other outcomes are certainly possible.

Mr. MCDERMOTT. I tell you what I am worried about. It is that we are going to get into 1992, in an election year, and you are going to be in here for another $40 or $50 or $60 billion for the banking system; I want to hear you say today that is not going to happen.

Mr. BOVENZI. I would not say that today. I am trying to make quite clear that these estimates are dependent upon economic conditions. I don't think anybody can say for certain what those economic conditions are going to be. I would never give that certainty.

We have made two forecasts and projections. One based upon basically the administration's forecast for the economy. That is our baseline estimate. The second being more pessimistic, assuming the recession continued through 1991. I don't know for sure when the economy will improve.

But if the recession continued through 1992, the numbers would be worse than the pessimistic scenario. These are not intended to represent best-case and worst-case scenarios; they are intended to represent all the information we have now, what are the most likely scenarios.

Mr. MCDERMOTT. Do you include in your assumption what is going to happen to the Fed using the assumed interest rate, for instance?

Mr. BOVENZI. That would be part of what is affecting the economy, in terms of when the economy turns around.

When you are talking about all the large number of failures, even if the economy turned around within a month or so, you will still get a good number of bank failures because the banking industry's turnaround always lags the general economic turnaround. Once the banks make those loans, they are already on the books. It takes them a little longer to turn around than the economy as a whole.

Mr. MCDERMOTT. Does the pessimistic estimates say that the basic interest rates will stay the same or drop?

Mr. BOVENZI. We have not factored in any particular interest rate in there. What we do in coming up with our bank failure numbers is go directly to the bank examiners out in the region, the people directly supervising those banks. We say use your view of that bank and its unique characteristics and conditions and tell us whether you think there is a high likelihood of failure, based upon the economy either improving soon or the economy staying weak throughout the year. And you tell us which banks you see as likely to fail.

Rather than using a modeling approach that factors in all of these things as some other agencies have done, we feel what we can add is our direct experience with each insured bank and what the examiners who work with those banks feel about them.

Mr. McDermott. You are saying if things don't pick up fairly shortly, you have a list of actual banks that the examiners have been in and looked at of up to 440 banks that will fail or may fail over the next 2 years? In other words, you have already looked at each bank, bank by bank and put names on a list and said these are the ones that will be gone in 2 years?

Mr. Bovenzi. There is a list. They are all probabilities. They would be high probabilities, since forecasting out over a 2-year period you don't have certainty on such things. So we try to use our best judgment, bank-by-bank, as to which ones will fail, and what their cost would be to the insurance fund and build in factors that there will always be uncertainties that we won't see in advance and include that in the estimates as well.

Mr. McDermott. You didn't use any econometric model? It has simply been looking at the banks. If we ask you, could you tell us a particular bank in my State, if it is on that list?

Mr. Bovenzi. I would not talk about any individual bank and whether it was on a list or not.

Mr. McDermott. We just have to see when the plane takes off or when it doesn't take off?

Mr. Bovenzi. That is correct.

Mr. McDermott. Mr. Chairman, thank you.

Mr. Pickle. Mr. Chairman, may I say this?

In light of Mr. McDermott's question, I am alarmed that you tell me that possibly 400 banks have been examined and you feel they are in danger of going under if some extra assets or liquidity is not given to them within the next year or two.

Yet, you have allowed the FDIC fund to go down to the $1 to $6 million level. It seems to me like you are waiting until the very last minute for Congress to respond. Why have you not come before us to ask for some help prior to this moment?

Mr. Bovenzi. For months we have been pointing out the problem. As all of us who have presented projections in this area have stated, there is considerable uncertainty, and much depends on economic conditions which change a great deal.

Mr. Pickle. You have had almost 2 years of history with the savings and loan. That hasn't worked. So what makes you think now it is going to turn around within the next year or two, that you won't need these funds?

Mr. Bovenzi. We are asking for them specifically because there is a strong likelihood we will need some amount of these funds. We can't say because we don't know exactly how much of that we would need to borrow.

Mr. Pickle. Do you—can you raise additional money now by just making an assessment against a bank?

Mr. Bovenzi. We have authority to change the assessment rate; is that correct?

Mr. Pickle. Could you raise enough to puff up your funds immediately?

Mr. Bovenzi. We raised the assessment effective midyear from 19½ to 23 cents. We have made the judgment that it makes more sense to do this gradually, that the industry can only pay so much all at once and that there are legitimate credit needs out there. We do not want to stifle credit as well by putting a tremendous hit on the banks.

Mr. Pickle. You want to borrow $25 billion. The only way you can pay that back, as I understand it, is through your premium going up to 30 cents of $100 or the sale of assets. The prospects of your sale of assets are not very good at the level that you anticipate. The premium is an arbitrary figure.

If you don't get the money through those two sources, then the taxpayers are going to have to pay extra money; is that not correct?

Mr. Bovenzi. That is correct.

Mr. Pickle. The two pockets are probably not going to work. The prospects of it are going to cost the taxpayer money.

Mr. Bovenzi. I would not phrase it that way. I believe the prospects are they are going to work.

If you talk about the value of assets being low and those assets are backing up the borrowings for liquidity needs, that value is taken into account right up front in what you borrow. That is factored into the estimate. So there is a safety margin there.

The banking industry can repay the amount of negative net worth under any of the scenarios being presented by not only the FDIC, but all the outside consultants and agencies who have looked at the problem. Under everything that we see right now the industry is quite capable of paying back any borrowings.

There is never a 100-percent certainty on the future because one can never with 100-percent certainty say what the economic conditions will be.

Mr. Pickle. Have you talked to the banks? Have the banks across the country expressed a willingness to assume that extra premium up to 30 cents?

Mr. Bovenzi. We talked quite extensively with the banking industry and the banking trade associations and all their leaders. For the most part they were grudgingly raising the premiums.

Like Mr. Glauber said, that is never agreed upon unanimously.

Mr. Pickle. They are grudgingly receptive?

Mr. Bovenzi. Nobody likes to see costs go up. Perhaps that was poorly phrased.

Mr. Gibbons. Thank you, sir.

Next we have a panel of Price Waterhouse and Privacy Times Newsletter.

Mr. Neubig.

STATEMENT OF THOMAS S. NEUBIG, DIRECTOR, FINANCIAL SECTOR ECONOMICS, PRICE WATERHOUSE

Mr. NEUBIG. I appreciate the opportunity to testify on the current tax rules governing financial institutions and also to address whether the committee should reconsider these rules in light of the proposed expansion of banking powers. I am responsible for the financial sector economics practice of Price Waterhouse and specialize in the Federal and State taxation of financial institutions.

My testimony identifies current tax rules that are unique to the charter of specific institutions. These special charter-specific rules can influence the market share, investment and product choice, and also the corporate structure of the financial services industry.

When I talk about financial services institutions, I talk about banks, mutual funds, security firms, life insurance companies, property casualty insurance companies and also general business corporations, many of which have finance companies.

The tax rules for these financial institutions have been changed substantially during the last decade. In particular, the tax rules for depository institutions and insurance companies have been made a lot more similar to each other and also to the rules for general corporations.

However, there are still a number of tax rules for banks and competing financial institutions that depend upon the specific charter of the institutions. For instance, there are special bad debt reserve rules for thrift institutions that are not available to other corporations.

These differential rules can result in different tax costs for providers of essentially the same products. In such cases what happens is the higher taxed institutions would either not sell in a particular market, would have a lower market share because they would have a higher price, or they would have an incentive to sell through an affiliate with a different charter rather than selling directly.

To identify a charter-specific tax rule, one can ask the following question: If a product or service could be sold by a bank, insurance company or a general business corporation, would there be any difference in the tax cost depending upon which type of company offered the product?

If the answer is yes, then I think the corporate tax rules are a potential impediment to financial deregulation.

Since one of the stated purposes of the banking reform legislation is to remove such impediments, I think it may be useful in the future for this committee to review the specific objectives of the special rules to see whether or not these objectives are being achieved and are still desired.

In my written testimony I have identified nine possible issue areas where the current tax rules differ by the charter of the institutions. What I would like to do is briefly mention three examples of these charter-specific rules.

The first issue is the tax treatment of bad debt losses. The 1986 act repealed the bad debt reserve rule for all taxpayers, banks and general business corporations, and left the reserve rule just for certain thrift institutions and small banks. Other taxpayers now use the specific chargeoff method, where a deduction for bad debt losses is taken at the time that a specific debt becomes partially or totally worthless.

With the repeal of the bad debt reserve method, a number of taxpayers are concerned about the administrative and compliance burdens of determining when a bad debt becomes worthless.

Yesterday Treasury issued regulations making the regulatory presumption for banks more consistent with the regulatory review of bank loan systems rather than on an individual loan-by-loan basis. Nonbanking loan lenders do not have a conclusive presumption for their financial statement chargeoffs.

This difference could encourage lending for certain activities to be conducted through a bank rather than through a nonbank affiliate. The Treasury Department is doing a study and I look forward to seeing whether or not they would propose providing some type of conclusive presumption for nonregulated lenders.

The second issue is the deduction of interest on debt financed tax-exempt bonds. Under current law there are five different sets of rules for the treatment of interest paid to purchase or carry tax-exempt bonds.

You have a set of rules for general business corporations, dealers in tax-exempt obligations, banks, life insurance companies, and property and casualty insurance companies. The specific rules are described in my testimony.

Because of these differences, the financial services holding company would have an incentive to alter the investment portfolios of its separate affiliates. Small issuer bonds would be held by the bank affiliate while other tax-exempt bonds might be held by the property casualty insurance company or a nonfinancial affiliate.

The final example of a charter-specific tax rule is the consolidation rules for life insurance companies. Unlike other financial institutions or their nonfinancial corporations, life insurance companies are subject to special rules that limit the amount of nonlife losses that can offset life insurance company income in a consolidated return.

These special rules date back to the 1959 life insurance company rules and all of its bizarre provisions. It is difficult to understand the continued need for special consolidation rules for life insurance companies after the recent tax overhaul of the life insurance rules.

Bank net operating losses within a financial services holding company could be used fully against any other type of corporate income except from a life insurance company. Such a restriction would be a tax impediment to full utilization of the expanded banking powers envisioned in the legislation.

In conclusion, the tax legislation during the 1980s has moved the taxation of depository institutions, insurance companies, and other corporations much closer together.

The remaining tax differences based on a financial institution's charter, I think, do merit reconsideration at some future date if the proposed banking powers are enacted.

Such a review would ensure that the special tax rules' objectives are still desired and that the objectives are being achieved. There are some possible simplification measures that could occur in this area as well.

[The prepared statement follows:]

STATEMENT OF
THOMAS S. NEUBIG
DIRECTOR OF FINANCIAL SECTOR ECONOMICS
PRICE WATERHOUSE
BEFORE THE
WAYS AND MEANS COMMITTEE
MAY 29, 1991

Dear Mr. Chairman and Members of the Committee:

I appreciate the invitation to testify on whether the current tax rules governing banks and competing financial institutions warrant reconsideration in light of proposals to expand the allowable activities of banking corporations.

I am responsible for the Financial Sector Economics practice of the Washington National Tax Service office of Price Waterhouse. I am a senior manager specializing in the federal and state taxation of financial institutions. Prior to joining Price Waterhouse last year, I was Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis. I was with the U.S. Treasury for over nine years and was involved in the tax law changes affecting financial institutions during the 1980's.

The purpose of my testimony is to identify current Federal tax provisions which potentially merit future review given proposals to further deregulate the financial services industry, and specifically to expand the powers of banking corporations and to allow banks to be owned by commercial companies.

In determining whether to reconsider the tax laws for banks and competing financial institutions, it is useful to identify the current tax rules unique to the charter of specific institutions. Charter-specific tax rules can influence the market share, investment and product choice, and corporate structure of the financial services industry. An evaluation of the purposes and economic effects of these tax rules, however, is beyond the scope of this testimony.

BACKGROUND

The tax rules governing banks and other depository institutions, life insurance companies, property and casualty insurance companies, brokerage and security firms, and general business corporations have been changed substantially during the last decade. In particular, the tax rules of depository and insurance institutions have been extensively reviewed and moved closer to the tax rules of each other and to those governing general business corporations.

Nonetheless, the tax rules for banks and competing financial institutions differ in some areas. In some cases, this reflects specific policy objectives. In others, it may reflect the then existing regulatory and market structures of the financial services industry. In addition, the tax changes during the 1980's generally focused on specific sectors of the financial services industry, rather than forming part of a comprehensive review of the taxation of the entire financial services industry.

Expanded banking powers would mean more direct competition between different financial institutions. Banks and certain thrift holding companies are already competing in many aspects of the securities and insurance business. It is also important to note that many general business corporations are competing directly with regulated financial institutions. Many large corporations have finance subsidiaries with all types of lending activities. They also self-insure against health and property/casualty insurance risks or have captive insurance companies. Also, some have entered the regulated financial institution business through the acquisition of "troubled" thrift institutions.

Tax rules that depend on the specific charter of the institution may result in potential tax distortions, which could affect the market share or corporate structure of the financial service providers. Differential tax rules based on the charter of the institution may result in different tax costs for providers of the same products. In such cases, the higher taxed institution would either not sell in a particular market, have a lower market share, or have an incentive to sell a particular product through an affiliate with a different charter rather than directly.

The issue of competitive balance raises the following question: If a certain product or service could be sold by either a bank, insurance company or general business corporation, would there be a difference in the tax cost depending on which type of company offers the product or service? Tax rules in a deregulated market could be based on the type of activity or product sold, rather than on the charter of the corporation. Thus, definitions of financial institutions and insurance companies would be much less relevant, while definitions of activities and products would be more relevant. I recognize that non-tax considerations might still require that certain non-traditional banking activities be required to be performed in separately chartered entities, for example, to reduce the risk of exposure with regard to federally-insured deposit accounts.

Since one of the stated purposes of the banking reform legislation is to reduce inefficiencies in the provision of financial services, differential tax rules across financial institutions merit future review to ensure that the specific objectives are still desired and are being achieved. I would urge the Committee in such a review also to consider possible simplification measures in this area.

CURRENT TAX RULES DEPENDENT ON THE CHARTER OF THE FINANCIAL INSTITUTION

In this section, I identify and describe current tax rules which depend on the type of charter of the financial service provider. If expanded banking powers are enacted, these tax areas would merit future review.

1. Definitions of Companies and Activities

The proposed expansion of banking powers would place additional pressure on the distinction between banks and insurance companies to the extent that different tax rules apply to different types of institutions. Businesses would have an incentive to have certain activities conducted in institutions with the more favorable tax rule, rather than where it is most economically efficient to produce the activity.

Under current law, there are different tax rules for different types of institutions. Regulated depository institutions are subject to rules in Subchapter H, while insurance companies are subject to rules in Subchapter L. Thus, the Internal Revenue Code contains statutory definitions of banks, life insurance companies, and insurance companies.

The Code defines certain financial activities for specific purposes. Insurance income is defined for purposes of the Subpart F rules and for the life insurance business of mutual savings banks. The Code also contains a definition of life insurance, but not a definition of "insurance," an issue which is currently being considered by several courts. For capital gains purposes, the Code distinguishes between a securities "dealer" and a securities "trader".

It is important to note that if differential tax rules apply to different activities, then there would be economic incentives to undertake more of the lower taxed activity and to classify activities as the lower-taxed activity.

2. The Tax Treatment of Bad Debt Losses

Depository institutions in their intermediation role between borrowers and lenders bear the risk of losses from bad debts. All lenders bear a similar risk from their lending activities. Prior to 1987, all businesses could deduct losses on business debts using either the specific charge-off method or a reserve method. Depository institutions could chose from alternative reserve methods.

The 1986 Act repealed the bad debt reserve method for all taxpayers, except for thrift institutions (which meet certain tests primarily based on housing-related investments) and small banks. A small bank is defined as a bank (or any controlled group of which the bank is a member) with total assets of $500 million or less. Thrift institutions (mutual and stock savings banks, domestic building and loan associations, and cooperative banks) are able to use an experience-based reserve method or a percentage of taxable income method, currently eight percent of taxable income. This latter method has historically been viewed as a subsidy to encourage residential lending, even though it has been included in the bad debt reserve rules rather than as a reduction in the thrift institutions' statutory corporate tax rate.

Most taxpayers, including large banks, now use the specific charge-off method, where a deduction for bad debt expense is taken at the time a specific debt becomes partially or totally worthless. The determination of worthlessness for tax purposes is based on the facts and circumstances of individual loans. With the repeal of the bad debt reserve method, taxpayers are increasingly concerned about the administrative and compliance burdens of bad debt chargeoffs for tax purposes.

Regulations allow banks and thrift institutions a conclusive presumption of worthlessness for total or partial charge-offs directed or subsequently confirmed by the appropriate regulator in written form. At the current time, not all banks and thrifts are issued confirmation letters for specific assets by their regulator, and thus cannot use the conclusive presumption.

In the 1986 Act legislative history of the repeal of the bad debt reserve deduction for non-depository institutions, Congress requested a Treasury Department study of appropriate criteria for determining the worthlessness of business debts. In addition, the study is to evaluate under what circumstances a conclusive or rebuttable presumption is appropriate for all taxpayers.

3. Tax Treatment of Tax-Exempt Interest and Certain Dividends

Current law generally disallows a deduction for interest on debt-financed tax-exempt bonds. A deduction is disallowed if there is nexus between the borrowing and the tax-exempt investment. However, attribution of borrowing to specific investments is administratively difficult given the fungibility of investments and borrowing. Specific allocation rules for interest of banks and thrifts and for insurance reserves of insurance companies have been enacted. At the current time, depending on the type of institution and the type of activity different rules apply.

General business corporations are subject to I.R.C. Section 265(2), which generally involves direct tracing between the borrowing and the specific tax-exempt bond investment. A safe-harbor for "insubstantial" investments in tax-exempt bonds of two percent of total assets has been allowed administratively.

Dealers in tax-exempt obligations are disallowed an interest deduction when they incur or continue debt for the purpose of holding tax-exempt obligations, even obligations held for resale. An allocable portion of interest is disallowed, although the disallowance does not apply to all indebtedness.

The 1986 Tax Act disallowed 100 percent of interest expense allocable to newly-acquired tax-exempt obligations held by banks and thrift institutions. A 100 percent interest disallowance makes investments in tax-exempt bonds unattractive for banks and thrifts, given the already reduced yield (implicit tax) that they receive (pay) on tax-exempt bonds. An exception is provided for bank or thrift purchases of certain small issuer tax-exempt bonds, which are subject to a 20 percent disallowance.

Since 1959, life insurance companies have been subject to "proration" rules which allocate a portion of tax-exempt bond income and certain dividends subject to the dividends received deduction to policyholder reserves. This has the practical effect of reducing the policyholder reserve deduction, similar to the banks' 100 percent disallowance of allocable interest deductions.

Property and casualty insurance companies are subject to a 15 percent proration rule for tax-exempt interest and the deductible portion of dividends received (with special rules for dividends that are 100 percent deductible). The deduction for losses is reduced by 15 percent of the insurer's tax-exempt interest and dividends received deduction.

4. Acquisition Costs of Insurance Policies

Insurance companies are subject to rules that attempt through a rough proxy to match income and expenses associated with insurance contracts crossing taxable years. The rules defer current deductibility of a fixed percentage of premiums and unearned premium reserve increases as a proxy for acquisition expenses.

The 1990 Act required that insurance companies capitalize and amortize certain policy acquisition costs over a ten year period. A fixed percentage of net premiums from life insurance, annuity, and noncancellable accident and health insurance contracts must be capitalized and amortized over ten years. "Small" insurance companies with assets of less than $500 million have a five year amortization period.

The 1986 Act required that property and casualty insurance companies reduce the deduction for increases in the unearned premium reserve by 20 percent. The 1990 Act extended the 20 percent unearned premium reserve disallowance to life insurance companies.

5. Pass-through and Tax-exempt Entities

The financial service industry's intermediary role raises the general issue of whether income should be subject to more than one level of tax. One of the major efficiency gains from financial intermediation is from portfolio diversification. Individuals can hold financial instruments directly, but they may prefer the diversification possible from an equity share in a diversified portfolio offered by a financial intermediary.

If individuals hold income-producing assets directly, the income would be subject to tax once at the individual level. If they hold the same income-producing assets through a corporate financial intermediary, the income might be subject to more than one level of taxation, i.e., tax at both the individual and intermediary level. Pass-through treatment has been provided for certain types of financial intermediation. Mutual funds (through regulated investment companies), bank common trust funds, REITs (real estate investment trusts), and REMICs (real estate mortgage investment companies) are not subject to corporate level tax if they meet certain qualifications. These qualifications and requirements for pass-through status vary among the type of entity.

Tax exemption of certain financial institutions is somewhat similar to pass-through status, since most of the income flowing through a depository institution is subject to individual income tax as interest, dividends, or wages. Only retained earnings are not subject to current individual level tax. A number of financial institutions have been made subject to corporate tax on their retained earnings due to concerns about competition with taxable service providers. Congress has chosen to exempt certain financial institutions from corporate taxation. Standards appropriate for tax-exempt status, whether by charter, size of company, or by type of community benefit or service, may merit review in the financial services sector.

6. Tax Treatment of Gain or Loss From Securities

As a general rule, the sales or exchanges of securities are treated as capital transactions. Thus, the income or loss is treated as capital gain or loss. Although tax rates for ordinary and capital income are now identical for corporations, corporations are limited to using capital losses against capital gains in the current year with unused capital losses subject to a limited carryback and carryforward period.

A "dealer" in securities who purchases and resells securities to customers must treat the securities as inventory. In this case, the gain or loss is treated as ordinary income or loss.

IRC Section 582(c) allows banks and thrift institutions to treat gain or loss from sales or exchanges of bonds, debentures, notes, other certificates of indebtedness, or any interest in a REMIC (real estate mortgage investment company) as ordinary income or loss. Section 595 requires certain thrift institutions to treat foreclosed property as a loan equivalent, thus ensuring that gain or loss is ordinary.

7. Consolidation and Recapture Rules

Life insurance companies that file consolidated returns with non-life insurance companies are subject to an additional limitation within the general consolidated return rules. Losses from non-life insurance companies are limited to the lesser of 1) 35 percent of the non-life insurance companies' losses or 2) 35 percent of the life insurance companies' taxable income. New affiliations of life insurance companies are not included in the consolidated return during the first five years after the affiliation.

Banking deregulation might trigger transaction or recapture taxes in certain mergers or reorganizations of financial service firms. H.R. 1505 would permit tax-free transfers of bank common trust funds to a registered investment company as a result of a merger, conversion, or reorganization. If a thrift were to become a branch of a bank or elect to convert to a commercial bank charter, then the amount of the thrift's outstanding bad debt reserve attributable to the percentage of taxable income in excess of the experience method might be recaptured, even if the percentage of qualified assets were to remain the same. Similarly, underwriting income of stock life insurance companies deferred prior to 1984 could be recaptured in certain mergers or acquisitions. If consolidations and freedom of business form are to be encouraged, consideration of the effect of these transaction taxes might be warranted.

8. Mutual Company Income

The taxation of mutual (policyholder or customer-owned) company income has been debated extensively during the 1980's in the context of life insurance companies. Mutual life insurance companies are subject to a limitation on their policyholder dividends. The Treasury Department recently issued a report that discussed the taxation of mutual property and casualty insurance companies. Although many depository institutions are mutual in organization, their deductible distributions to depositors have not been an issue.

9. Product Issues

The current taxation of financial products generally does not depend on the provider of the product, but rather on the characteristics of the product itself. Differential product taxation affects the demand for certain types of products, but under the proposed expansion of banking powers would not distort the choice of provider.

Differential taxation of products dependent on the charter of the financial institution did occur with the tax-exempt All-Savers Certificates, which could only be issued by qualified depository institutions. In addition, the 1986 Act provided that individuals could elect to deduct losses on deposits in insolvent depository institutions as casualty losses, rather than as a short-term capital loss, and allow the loss to be reasonably estimated, rather than when there was no prospect for recovery.

SUMMARY

Proposals to expand the powers of banking corporations will have less tax effects today than they would have ten years ago. Recent tax legislation has moved the taxation of depository institutions, insurance companies, and general business corporations closer together.

Some tax differences based on the financial institution's charter or principal business activity still remain, and merit reconsideration in the future if the proposed banking powers are enacted. Tax rules based on the institution's charter, rather than on the specific activity or products sold, could affect the market share, investment and product choice, and corporate structure of the financial services industry. A review of these tax rules would ensure that their specific objectives are still desired and are being achieved, and could consider simplification in these areas as well.

Mr. GIBBONS. Mr. Hendricks.

STATEMENT OF EVAN HENDRICKS, EDITOR AND PUBLISHER, PRIVACY TIMES, WASHINGTON, D.C.

Mr. HENDRICKS. Thank you for the opportunity to testify before the committee.

I will be brief.

My name is Evan Hendricks. I am editor and publisher of the Privacy Times newsletter here in Washington. I started Privacy Times in 1981. I have been reporting on privacy and FOIA issues for 13 years. I am author of the book Your Right to Privacy.

Before the committee today are complex issues. I am in the fortunate situation of being able to simplify because I have been asked to testify about one section of the bill that would require all bank depositors to put their Social Security number or taxpayer identification number on their accounts for bank insurance purposes.

Simply, this is a bad idea. It will not solve the problem and it will create a new system of surveillance, of Government surveillance of millions of Americans based on their confidential financial data and their Social Security numbers.

In the 13 years I have been covering these issues, the complaint I hear most from individual Americans is about the overuse of their Social Security number, being asked for it in too many contexts.

Many of them remember, and others are aware of, the original promise printed on the Social Security card that it was not to be used for identification.

The calls I have received and the opinion polls show that most Americans feel that the new authorization of additional use of the Social Security number represents a continuation of a broken promise by the Government, and they want it stopped. They want this trend reversed.

Another troubling trend, and this current proposal represents it, is whenever we are faced with a major problem it seems there are some officials that come up with the idea that we need to create a new computer system to keep track of everybody as a solution.

I think sometimes maybe the pressure gets to these officials. The pressure builds and they feel if they can't come up with real solutions, they want to create the appearance that they are doing something about it.

It is almost like they are lying in bed trying to figure out what are we going to do about this. Then they jump up and say, I know, "We will just watch everybody."

We have the technology to do it. Unfortunately for Americans and their right to privacy, it is this attitude that placed their right to privacy under constant threat.

For example, the immigration bill, because of the perceived problems of too many undocumented foreigners, proponents wanted over 100 million Americans to carry a worker identification card, in effect, a national ID card.

Congress rejected this approach knowing most Americans find abhorrent the concept of carrying a national ID card. Congress also beat back an 11th-hour effort last year to sneak through a pilot project for a worker identification program in certain States.

In February, your Social Security Subcommittee held a hearing which demonstrated widespread opposition to the idea and hopefully will kill it off forever. I hope Senator Alan Simpson will take that testimony to heart.

I provide this background to demonstrate this proposal is part of this troubling trend of a nonsolution that we would create a new system of surveillance that most Americans would find repugnant. The committee should reject this proposal and send a message that similar ones in the future won't be tolerated.

From a privacy perspective, the proposal is offensive because it would require all bank customer banking accounts to be identified by the SSN for Bank Insurance Fund purposes.

This would create an entirely new purpose for the SSN, separate and unrelated from the use of Social Security numbers on interest-bearing accounts for tax reporting purposes. It also envisions a computer surveillance system capable of keeping tabs on all individual banking accounts just in case of the Government needs to ensure that individual is not over the limit for individual bank insurance funds.

To answer Mr. Archer's question earlier, "What does the Treasury Department really have in mind?" basically they want a systemwide surveillance system so that if individuals have more than $100,000 in more than one bank, they will be able to enforce a $100,000 limitation.

A glance at the numbers I feel shows what a preposterous proposal this is. It seems likely to me, without doing too much research, there are well over 100 million individual bank accounts in this country. Then consider how many individuals fall into the category of having more than $100,000 in two or more accounts, at different banks, that subsequently failed so the deposit insurance payments are required.

The officials at the FDIC with whom I spoke assured me the numbers of those in this category were a tiny fraction of the cases the FDIC examined.

An analysis of the numbers leaves us with the question, are we going to subject over 100 million individual banking accounts to nationwide computer surveillance in order to catch a tiny fraction of individuals that might be over the limit? The answer has to be "no."

The Subcommittee on Financial Institutions Supervision, Regulation and Insurance, as I understand, rejected this proposal. The FDIC said in their statement they don't need the proposal.

Let's keep in mind that this proposal will not solve the problem. Those intent on defrauding the system, and they say there has been organized crime influence in the savings and loan industry, will find ways of turning the system and exploiting it to perpetuate fraud. They will give different Social Security numbers, come up with fraudulent Social Security numbers.

You have heard of the idea of using a sledge hammer to go after a fly. I would like to expand on that because this is using a sledge hammer in a crowded room of people. Not only are you not going to kill the fly, you are going to bash in a couple of heads in the meantime, and these people are innocent. And when all the damages is done, the people are going to ask, "What was the sledge hammer doing there in the first place?"

We should be mindful that the central problem this legislation is supposed to address is the health of our financial institutions in the wake of too many bank failures.

Several factors have caused the run on bank failures, including bad management, outright fraud and the dramatic drop in real estate prices. Legislative solutions should be aimed at these problems. They must not allow the Government to set up a mammoth bank account surveillance system which would be used for additional purposes once it was up and running.

In conclusion, I would like to cite Supreme Court Justice William O. Douglas' 1974 dissent in opposing the Bank Secrecy Act requirement that all customer checks be recorded and available for Government inspection.

Justice Douglas improvised the fight against money laundering that started our Nation down a slippery slope in which privacy increasingly would be sacrificed.

He said,

> It would be highly useful to Government espionage to have like reports from all our bookstores, all our hardware and retail stores, all our drug stores. These records too might be "useful" in criminal investigations. * * *
>
> A mandatory recording of all telephone conversations would be better than the recording of checks under the Bank Secrecy Act, if Big Brother is to have his way. * * *
>
> In a sense a person is defined by the checks he writes. By examining them the agents get to know his doctors, lawyers, creditors, political allies, social connections, religious affiliation, educational interests, the papers and magazines he reads and so on ad infinitum. These are all tied to one's Social Security number * * *.

Now that we have the data banks, these other items will make it possible for a bureaucracy pushing one button to get at an instant the names of 190 million Americans who are subversives or potential and likely candidates.

I think as the committee considers this proposal, we should keep Justice Douglas' words in mind and send the message these sorts of spy systems are not going to be tolerated against the American people.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF

EVAN HENDRICKS
EDITOR & PUBLISHER

PRIVACY TIMES

Mr. Chairman, I'd like to thank you for this opportunity to testify before the Committee and for focusing attention on another proposed expansion of the Social Security number that will not solve the problem at hand and, at the same time, set a disastrous precedent for our national privacy policy.

My name is Evan Hendricks. I'm Editor/Publisher of PRIVACY TIMES, a biweekly, Washington-based newsletter that reports on legal, policy, industry and consumer news in the fields of privacy and freedom of information. I started PRIVACY TIMES in 1981. I have been reporting on privacy and FOIA issues for 13 years. I am author of the book Your Right To Privacy (SIUP-1990).

I am also chairman of the newly formed U.S. Privacy Council, which consists of privacy and consumer experts and academics. The Council's goal is to promote better protection of privacy through a variety of means, including legislative, judicial, education and public awareness, organizational policies and private enterprise.

Background

By way of background, it's important to note that we are at a stage of history where our rights to individual privacy are seriously threatened. There are many reasons. First, there is growing use of the Social Security number as a universal identifier. Second, advances in information technology allow for faster and easier gathering, sharing and manipulation of personal data. Third, there is easy access to volumes of personal data from both public and private sources. Finally, privacy laws, where they exist, are out of date and badly in need of strengthening. For some kinds of personal information, there are no controls.

These and other factors have created what I describe as a "Cowboy Atmosphere," in which large institutions and small entrepeneurs alike feel free to use, and as some see it, abuse personal data with little regard for the individual's concern for privacy.

There are legislative solutions to many of the privacy problems facing us. Some very good proposals, including ones to amend the U.S. Privacy Act, the Fair Credit Reporting Act and to create a Data Protection Board, are pending before this Congress, and I urge your support of them.

Sometimes defending privacy requires defeat of bad legislation. For instance, last year Congress rejected an effort by so-called immigration "reformers" to sneak through a pilot project requiring that everyone carry a worker identification card, using the Social Security number (SSN) as the key identifier, to show that one was legally eligible to work.

Most Americans find abhorrent the concept of a national identification card. The Committee's Subcommittee On Social Security deserves a lot of credit for holding a February 27 hearing, which revealed widespread opposition to the worker ID card proposal, as well as to the expanding, unauthorized uses of SSNs for identification purposes. I believe the Subcommittee's efforts will go a long way toward deterring immigration "reformers" from repeating their efforts to set up system of surveillance for American working men and women.

Americans Offended By Expanding SSN Uses

In 13 years of following privacy issues, the most consistent complaint I hear from individuals concerns the expanding, uses of SSN for identification purposes. It is clear to me that most Americans want the SSN to be restricted to its original purpose: wage and tax reporting.

The Social Security Card used to state: "This card is not to be used for identification." The promise in the early days that the SSN would not become an identification number has turned out to be one of the great lies to the American people, on par with other famous promises like, "Your Check Is In The Mail."

Clearly, the history of the SSN is a classic case study in the erosion of privacy. The SSN has proved to be the key element allowing computers to talk to eachother, to search through eachothers data files and to draw out profiles of individuals' lifestyles, spending habits and movements. Accordingly, the creation of one, centralized computer system on all Americans is no longer the only privacy concern. Now the interconnection of small computer networks, made easier by widespread use of the SSN, is creating an enormous system capable of data surveillance.

The original use of the SSN, of course, was to number personal accounts for the collection of taxes and benefits in the Social Security program. The first numbers were assigned in 1936. A year later, it was decided that the same identifier should be used to number accounts in state unemployment-insurance systems. In 1943, Executive Order 9397 was issued by President Roosevelt authorizing any federal agency to use the SSN for new data systems requiring permanent account numbers on records pertaining to individuals. This authority was not used for many years, even by the U.S. Civil Service Commission, for whose benefit it was originally intended.

In 1961, the Internal Revenue Service decided to designate the SSN as the taxpayer identification number. Thereafter, new uses followed in rapid succession: for Treasury Bonds, for old-age-assistance benefit accounts, for state and federal civil-service employee records, Veterans Administration hospital records, Indian Health Service patient records, and as the military-personnel service number.

Congress also encouraged this trend. Under the Tax Reform Act of 1976, it authorized states to use the SSN for motor vehicle registration records and driver's licenses. Currently, some three dozen states use the SSN as a driver identification numbers. This means the number often is recorded on checks as an ID number when consumers make purchases. The 1976 law also authorized SSN use for administration of local and state tax laws, of general public assistance programs and for implementation of the Parent Locator System.

Another major step came in 1984, when the Deficit Reduction Act required all depositors to provide to financial institutions their SSNs so IRS computers could match the amount of interest reported by taxpayers with amounts reported to the IRS by banks. The law also required recipients of federal benefits to provide social service agencies with their SSNs. The 1986 Tax Reform Act requires parents to show SSNs for children over the age of five who are claimed as dependents.

Despite all of these uses, the SSN still does not qualify as a "universal identifier," meaning there remain contexts in which people are not required to provide it for identification purposes. That is why it is important to stop efforts to mandate it as an identifier for additional purposes. Ideally, new restrictions should be placed on SSNs so that we may steadily return to government's original promise that the number would only be used for wage and tax reporting, and not for general identification purposes.

New Problem? Propose A System of Surveillance

Another troubling trend has been the tendency of some policymakers, when confronted with a new and pressing problem, to come up with proposals for new systems of surveillance which fail to provide any real solution to the problem at hand, and which set disastrous precedents for our national privacy policy.

The immigration proposal was a case in point. Because some officials thought there were too many undocumented foreigners in the U.S. looking for work, they thought the answer was to require all Americans to carry a national identification card. Those familiar with the realities of U.S. workplaces' need for employees, as well as economic and/or political situations in parts of Central America and Asia, knew that this proposal would have little or no impact on immigration to the United States. However, it would have set up a system of surveillance that could have been used for numerous additional purposes once it was up and running. Congress deserves credit for repeatedly rejecting this proposal and its homely offsprings.

Similarly, computer matching in federal programs was seen as a panacea for fraud and mismanagement. In fact, not only has the government for ten years not been able to prove that computer matching programs save taxpayer dollars, it has not even been able to come up with a methodology for calculating costs and benefits. (For more details on these examples, please see my February 27 testimony before the Subcommittee on Social Security.)

The Latest Banking Proposal: A Typically Bad Idea

This lengthy background is necessary to demonstrate that the current proposal to require SSNs on all bank accounts for insurance fund purposes, fits into the troubling trend of a "non-solution" that would create a new system of surveillance that most Americans would find repugnant.

The Committee should resoundingly reject this proposal and send a message that similar ones in the future will not be tolerated.

From a privacy perspective, the proposal is offensive because:

(1) It would require all customer bank accounts be identified by SSN for bank insurance fund purposes. This would create an entirely new purpose for SSNs, completely separate from the use of SSN on interest bearing accounts for tax reporting purposes.

(2) It envisions a computer surveillance system capable of keeping tabs on all individual bank accounts, just in case the government needs to ensure that an individual is not over the limit for insurable bank funds.

A glance at the numbers show what a preposterous proposal this is. Though precise numbers were not available to me, it seems likely there are well over 100 million individual bank accounts in this country.

Then consider how many individuals fall into the category of having more than $100,000 in two or more accounts at different banks that subsequently fail so that deposit insurance payments are required.

Again, I do not have a scientific estimate on how many people fit into this category. But the officials at the FDIC with whom I spoke assured me that the numbers of those in this category were a "tiny fraction" of the cases the FDIC had examined. By the way, FDIC officials with whom I spoke, and I'm not sure if they were speaking for the agency, expressed opposition to the proposal on the principle of expanding use of the SSN, and on grounds that it would not really accomplish anything constructive.

An analysis of the numbers leaves us with the question: Are we going to subject over 100 million individual bank accounts to nationwide computer surveillance system in order to catch a tiny fraction of individuals that might be over the limit? The answer has to be "No."

We should be mindful that the central problem the legislation is supposed to address is the health of our financial institutions in the wake of too many bank failures. Most would agree that several factors have caused the run of bank failures, including bad management and investment decisions, outright fraud and the dramatic drop in real estate prices.

All legislative solutions should be aimed at these problems. They must not allow the government to set up a mammoth bank account surveillance system that undoubtedly would be used for additional purposes once it was up and running.

In opposing Bank Secrecy Act requirements that all customer checks be recorded and available for government inspection, Supreme Court Justice William O. Douglas in 1974 prophesied that the fight against money laundering had started our nation down a slippery slope in which privacy increasingly would be sacrificed:

> It would be highly useful to governmental espionage to have like reports from all our bookstores, all our hardware and retail stores, all our drug stores. These records too might be 'useful' in criminal investigations. . . .
>
> A mandatory recording of all telephone conversations would better than the recording of checks under the Bank Secrecy Act, if Big Brother is to have his way. . . .
>
> In a sense a person is defined by the checks he writes. By examining them the agents get to know his doctors, lawyers, creditors, political allies, social connections, religious affiliation, educational interests, the papers and magazines he reads and so on ad infinitum. These are all tied to one's Social Security number; and now that we have the data banks, these other items will enrich that storehouse and make it possible for a bureaucrat -- by pushing one button -- to get in an instant the names of 190 million Americans who are subversives or potential and likely candidates. (California Bankers Association v. Shultz, [illegible]16 U.S. 735, 1974.)

Mr. Chairman, again I would like to thank the Committee for the opportunity to testify on this very important matter. I would be happy to answer any questions.

Mr. **Gibbons**. I think you have convinced me we don't need to do that. I don't know whether the rest of the Members feel that way or not.

Mr. Neubig, who is the best off as far as tax regulations are now concerned? Which of the five or so financial institutions? Who gets the preference?

Mr. **Neubig**. I have not attempted to do any empirical analysis in terms of which industry has specific rules.

Mr. **Gibbons**. Obviously, the savings and loans have the most generous.

Mr. **Neubig**. I don't want to speculate without having done the empirical work. They have special rules that have been targeted to their residential mortgage lending. There are other special rules in the Tax Code. In some cases, they work to the advantage of the industry. In other cases like the life, nonlife consolidation rules, they work to the detriment of the industry. I think they cut both ways.

Usually—I mean there has been a specific public policy objective that Congress intended when they included the provision in the code.

Mr. **Gibbons**. Do I interpret you correctly that you believe there ought to be uniform rules between each financial institution?

Mr. **Neubig**. Given the proposed expansion of banking powers, it is certainly worth Congress looking at tax rules that are charter specific. They might come to a determination that in certain cases the tax rules should not be perfectly uniform.

I think there is some definite merit in terms of uniformity. That has occurred over the last 10 years. I won't argue uniformity just for uniformity's sake. There may be social policy goals that outweigh tax policy goals.

Mr. **Gibbons**. Thank you for your testimony.

[Whereupon, the committee recessed.]

Afternoon Session

Mr. **Gibbons**. The meeting of the Ways and Means Committee will resume.

We have a panel composed of the American Bankers Association, Ms. Norma J. Lauder; the National Council of Savings Institutions, Mr. Kingman; National Association of Federal Credit Unions, Mr. Hughes; and the Securities Industry Association, Mr. Horowitz.

Ms. Lauder, you may start first.

STATEMENT OF NORMA J. LAUDER, CHAIRPERSON, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION (SENIOR VICE PRESIDENT AND DIRECTOR OF TAXES, FIRST NATIONAL BANK OF CHICAGO)

Ms. **Lauder**. Thank you, Mr. Chairman.

Mr. Chairman, I am Norma Lauder, senior vice president and director of taxes at First National Bank of Chicago. I am testifying today on behalf of the American Bankers Association, whose members make up virtually the entire banking industry of the United States.

As bankers and policymakers work to design a contingency plan for recapitalizing the BIF, it is important that a balanced approach be developed—an approach that will provide sufficient funds to ensure that BIF can close insolvent institutions, but will not unnecessarily constrain credit availability to consumers, businesses, and communities across the country. The House Banking Committee is now considering H.R. 2094 which addresses the BIF recapitalization.

Tax aspects of BIF recapitalization: There is a tax aspect of BIF recapitalization that requires attention by the Ways and Means Committee. Insurance payments paid by banks to the FDIC are substantial expenses. At the First National Bank of Chicago these will approximate $51 million at the 23-cent rate, compared to $18 million premium payment on the 8.3-cent rate just 2 years ago. These dramatically increased deductible BIF insurance premiums have focused attention on what we believe to be an unintended defect in the tax net operating loss rule for commercial banks adopted in 1986.

The ordering rule for the transition period years was drafted in the way that enhanced bad debt loss realizations in the case of carrybacks, but effectively prohibits banks from being able to utilize NOL carryforwards attributable to bad debts. This NOL limitation could place an additional cost on those banks seeking to raise capital critical to meet the Basel Accord.

The ABA recommends that the NOL role be revised by changing the ordering rule for carryforwards and/or by permitting banks to opt out of the transition rule early, as would have been allowed in a provision adopted by this committee in 1987.

Tax aspects of market changes and banking reform: The principal driving force behind the financial modernization legislation is the fact that the limited commercial bank franchise has been left behind in the real world marketplace. While banks have been operating under an outmoded legal structure, bank competitors have been very successful; in adapting their organizations and their products to meet the needs of financial service consumers. The question is, who are the bank's competitors? The examples on pages 4 and 5 of my testimony show that banks face enormous competition from nonbanks such as Prudential, American Express, Merrill Lynch, Sears, Ford Motor Co., and General Electric Corp.

Tax aspects of expanded products and services: The financial services holding company proposal raises level playing field issues in the tax treatment of banks, thrifts, insurance companies, securities firms, and mutual funds. Issues we have identified are first, the deductions for product losses; second, the interest expense disallowance related to tax-exempt income; and third, the sale or exchange of debt obligations.

We believe it is too early to make specific legislative recommendations now, but these tax issues should be explored relative to the changes in the marketplace, especially if banking reform legislation is enacted. Current law section 594, which allows mutual savings banks to be taxed as insurance companies on their life insurance income could be a model provision for leveling the playing field between different but competing institutions.

Treasury has already identified and included in H.R. 1505 one tax change related to banking reform which we support concerning common trust funds.

Bank common trust funds—section 245 of H.R. 1505: A bank common trust fund is a vehicle for the combined investment of trust accounts held by a bank as fiduciary. Treasury's proposal would permit a common trust fund to be converted to a mutual fund without triggering the consequences of a sale to the trust or its participants. The fund participants would benefit from the decision to convert as the cost of maintaining the fund would be spread over a much larger number of customers.

Taxation of competing depository institutions: Finally, we believe that the committee's inquiry into the level playing field issues would be incomplete without consideration of tax issues affecting some traditional competitors such as, specifically, the special bad debt reserve for thrifts and the tax exemption for income earned by credit unions.

Conclusion: ABA appreciates the opportunity to comment on both the debt management and tax aspects of the administration's banking reform proposals. The changes we have recommended for immediate action relating to the NOL rules, the treatment of transfers of common trust funds, the bad debt reserve for thrifts and the taxation of credit unions, taken together are likely to be at least revenue neutral. While the remaining issues we identified may not be ripe for enactment as part of H.R. 1505, we do believe that the committee should study the issues raised today so that we can work towards fair taxation of competing and affiliated financial institutions.

[The prepared statement follows:]

STATEMENT OF NORMA J. LAUDER ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

MAY 29, 1991

INTRODUCTION

Mr. Chairman and members of the Committee, I am Norma J. Lauder, Senior Vice President and Director of Taxes at First National Bank of Chicago. I am testifying today on behalf of the American Bankers Association, where I chair the ABA Taxation Committee and serve on the ABA Government Relations Council and the Banking Leadership Conference. The member organizations of the American Bankers Association range in size from the smallest to the largest banks, with 85 percent of our members having assets of less than $100 million. The combined assets of our members comprise about 95 percent of the total assets of the commercial banking industry.

The ABA applauds this Committee for taking an active interest in the proposed legislation to modernize our Nation's financial system. Our goal is simple -- a safe and sound financial system that provides high quality products and services at reasonable prices. Achieving this goal, however, will be far from simple. The market place for financial services has changed and, as I will describe in greater detail, there are many non-bank companies which offer financial services in competition with commercial banks. Therefore, accomplishing our goal will require a comprehensive overhaul of the existing framework of federal laws including three key elements -- modernization of our outdated financial structure, deposit insurance reform, and a contingency plan to recapitalize the Bank Insurance Fund (BIF).

The ABA has a position on all the major issues in the Administration proposal, developed over long hours of discussion with all of the leaders of our diverse industry, but my remarks this morning will be confined to the points raised by Chairman Rostenkowski's announcement concerning the hearing, specifically the tax and debt management aspects of the proposal. My testimony is divided into three parts;

- Recapitalization of the Bank Insurance Fund
- Tax Aspects of Market Changes and Banking Reform
- Taxation of Competing Depository Institutions

RECAPITALIZATION OF THE BANK INSURANCE FUND

The ABA recognizes the deep concern of members of Congress about the health of the Bank Insurance Fund. The S&L disaster, which continues to grow in size, has understandably led Members of Congress to want to do everything possible to minimize any risk to the taxpayers posed by the Bank Insurance Fund. The banking industry is committed to assuring the viability of the fund. It should be remembered that in contrast to the savings and loan industry, commercial banks have a strong and growing capital base of over $274 billion in equity capital and reserves, as well as current earnings for 1990 of over $16 billion. Moreover, banks have had more vigorous regulators, higher capital standards, tougher regulatory requirements, and more experienced management.

As bankers and policy makers work to design a contingency plan for recapitalizing the BIF, it is important that a balanced approach be developed -- an approach that will provide sufficient funds to ensure that BIF can close insolvent institutions, but will not unnecessarily constrain credit availability to consumers, businesses and communities across the country. Funds sent by banks to the FDIC cannot be loaned in local communities. In depressed areas, this loss of loans would be especially painful; small businesses, which are not able to access the public credit markets and are therefore heavily dependent on bank credit, are likely to suffer the most.

Moreover, the higher premiums required to pay for the recapitalization will reduce the value of failing institutions by making the most salable item -- the deposit base -- less attractive to potential buyers. Thus, the FDIC will face greater costs and difficulty in dealing with bank failures. And, of course, higher premiums will push some banks into insolvency. At some point, raising premiums would be counter productive -- raising less income for the FDIC than the cost of additional bank failures.

Banking Industry Recapitalization Plan

Earlier this year, industry leaders from the five major bank trade associations met at the ABA and worked together to structure a contingency plan to provide liquidity to the BIF if and when it is needed in the next two years. Under the plan, the FDIC would raise funds through the sale of bonds to the banking industry to use on a "as needed" basis to resolve insolvent institutions. The principal and interest on these bonds would be paid by the banking industry through a special assessment. While the Banking Committee is now working on an alternative funding proposal, the banking industry contingency plan was recognized as a constructive proposal to meet the current needs of the BIF without recourse to borrowing from the Treasury Department.

On May 7, 1991 the House Subcommittee On Financial Institutions Supervision, Regulation and Insurance reported out H.R. 2094, which contains the Bank Insurance Fund recapitalization provisions. The Subcommittee voted to give the FDIC greater flexibility to borrow for working capital and loss purposes. Specifically, it increased the limit on FDIC borrowing authority from $5 billion up to a maximum of $30 billion. The collateral for FDIC borrowing of working capital is based on 90% of the fair market value of the assets held by the FDIC. The repayment schedule worked out between FDIC and Treasury will be reported to the House Banking Committee. H.R. 2094 also authorizes the FDIC to impose a special assessment on banks as necessary to repay amounts borrowed from the Treasury or for any other purpose.

Too Big to Fail

The industry's recapitalization plan recognizes that simply putting more money into the BIF, without fixing problems in the laws governing our financial institutions, is not the ultimate answer. Policy changes, such as financial modernization to improve the future earning power of the banking franchise, renouncing too-big-to-fail and adopting early intervention procedures, are essential reforms for the long-run health of the fund. The use of a too-big-to-fail policy to prevent economic instability ("systemic risk") is not a legitimate function of deposit insurance and under no circumstances should FDIC funds be used to pay the extra costs involved when uninsured depositors receive full protection in a bank failure.

The implications of the FDIC's ad hoc policy of 100 percent coverage are becoming clear. On the surface, it would seem that covering all depositors would be a stabilizing influence by preventing possible disruptions in deposit markets. In reality, 100 percent deposit insurance has significant adverse long-term consequences for the industry and the economy.

Protection of all deposits, whether or not they are legally entitled to insurance, creates an enormous and unnecessary liability for the FDIC and potentially for the taxpayer. As the current policy of 100 percent protection becomes increasingly embedded in the minds of investors -- as is happening, no doubt, following the full protection afforded to depositors in the Bank of New England -- it will systematically erode the incentives of investors in large deposits to choose their banks based on the soundness of the bank, at least if the bank is large. The result is to encourage funds to flow to the highest bidder, regardless of risk.

In a *de facto* 100 percent deposit insurance world, the deposit insurance funds are burdened with costs they were never intended to bear. The policy also discriminates against smaller banks which are not considered too big to fail. In order to protect the taxpayers against an enormous risk, the Congress should eliminate "too big to fail".

Tax Aspects of BIF Recapitalization

The tax consequences of the Bank Insurance Fund recapitalization plan have been a moving target as various options have been raised and considered by the Treasury, the FDIC, the industry and now the Congress. Based on the recently reported H.R. 2094, the elements of the plan are limited to the amount of the borrowing authority of the FDIC and the amount of insurance premiums charged to banks. As a result, there is only one urgent tax issue that requires attention in connection with the plan. It should be remembered, however, that if the elements of the BIF recapitalization plan change, other significant tax issues could arise.

Insurance payments by banks to recapitalize the Bank Insurance Fund, including the recent increase in the regular insurance premiums of over 177% in less than 2 years, (from 8.3 cents per $100 in 1989 to 23 cents per $100 starting July 1, 1991) and a possible special assessment, are tax deductible expenses. These increased deductible (non-bad debt) costs have focused attention on what we believe to be an unintended defect in the drafting of the tax net operating loss rule for commercial banks adopted in the Tax Reform Act of 1986. The ABA urges that the NOL rule be amended by this Committee as part of its consideration of the banking reform legislation so that the increased insurance payments by banks will not result in substantial unused NOL carryforwards of bad debt losses.

In 1986 Congress sought to adopt a net operating loss carryover rule for banks and thrift institutions that was the same as other corporate taxpayers. A transition rule, however, was provided for large banks that was intended to ease the impact of this change and the elimination of the loan loss reserve. The 1986 Blue Book states,

> *The Congress was aware that the immediate application of such a change to commercial banks in concert with the repeal of the reserve method of computing a deduction for bad debts could have an unnecessarily adverse impact upon the deferred tax accounts that such taxpayers keep for financial and regulatory accounting purposes. Accordingly, the ten year carryback period of prior law is retained for such taxpayers for taxable years beginning before 1994 for the portion of a net operating loss attributable to deductions for bad debts. (p. 567)*

Under the transition rule, NOLs from bad debts can be carried back ten years and forward five years. NOLs from non-bad debt expense can be carried back 3 years and forward 15 years. The ordering rule which was included in IRC Section 172 to clarify the application of these two separate NOL rules was drafted in the way that enhanced bad debt loss realizations in the case of carrybacks, but effectively prohibits banks from being able to utilize NOL carryforwards attributable to bad debts. While the language of the ordering rule applies consistently to both carrybacks and carryforwards, the effect of the rule is inconsistent with the intent of the transition rule as a whole. This problem will be compounded as banks have higher non-debt expenses from the greatly increased FDIC insurance premiums. This defective provision requires that all NOL carryforwards attributable to non-bad debts (which expire in 15 years) be used up first, even though the bad debt loss carryforwards expire first. Thus, many banks will be forced to give up bad debt loss carryforwards.

The ABA recommends that the NOL rule be revised legislatively as a technical correction of the Tax Reform Act of 1986. The Committee should explore whether to resolve this problem by changing the ordering rule for carryforwards and/or by permitting banks to opt out of the transition rule early, as allowed in a provision adopted by this Committee in 1987, but not enacted into law. This correction is needed to preserve the balance described earlier, by not taking too much out of the banking system either through increased insurance premiums or, in this case, by cutting off legitimate tax deductions.

TAX ASPECTS OF MARKET CHANGES AND BANKING REFORM

The principal driving force behind the financial modernization legislation is the fact that the limited commercial bank franchise has been left behind in the real world market place.

While banks have been operating under an outmoded legal structure, bank competitors have been very successful in adapting their organizations and their products to meet the needs of financial service consumers. On the liability side of the balance sheet, mutual funds, money market funds, cash management-type accounts and insurance products are attracting hundreds of billions of savings and investment dollars which in the past would have gone to depository institutions. On the asset side, non-bank financial firms perform many of the commercial and consumer lending functions traditionally provided by banks, and access to capital markets, either directly or through securitization, has become an attractive alternative to traditional bank loans.

The magnitude of the markets developed by bank competitors is enormous. Assets of all mutual funds and money market funds currently stand at **$1.1 trillion**. In fact, the assets of all mutual funds have grown at a compound annual rate of over 24 percent over the past decade, while domestic deposits have grown at less than a nine percent annual rate.

Similarly the commercial lending function is changing dramatically. In 1970, commercial lending at large banks accounted for 65 percent of the total short-term borrowing of domestic non-financial corporations; by 1990, it had fallen to 37 percent. Much of the decline in the market share of commercial and industrial loans was due the increasing use of commercial paper. The commercial paper market is huge -- over **$560 billion** outstanding as of year-end 1990. In part, this tremendous growth is linked to the increasing demand for short-term securities generated by money market funds. In other words, banks are losing on both sides of the equation -- deposit dollars are being lost to money market funds, which are then using the funds to buy commercial paper, which is a substitute for bank loans.

The financial modernization elements of the Administration plan are intended to address these changes in the marketplace for financial services. As indicated by Chairman Rostenkowski's announcement for this hearing, the changes in the banking laws raise questions about the proper tax treatment of the banks and the businesses that compete with banks by offering financial services to consumers. **The question is, Who are the banks' competitors?** Nonbank providers of financial services which involve affiliations of securities firms, insurance companies, and real estate brokerage firms are common already. These firms are taking advantage of their greater freedom to develop and market combinations of financial products that banks cannot offer.

Lets look at some examples of the financial activities of these firms.

- **Prudential Insurance Company**, the largest life insurance company in the country, owns Prudential-Bache, the tenth largest securities firm; the Prudential Bank and Trust Company, an FDIC insured bank; and Prudential Real Estate, a large real estate brokerage firm with 900 sales offices and 25,000 sales associates in 39 states. Through this network of affiliated firms, Prudential offers FDIC-insured deposits, credit card services, retail securities and commodities brokerage, mutual funds, securities underwriting and brokerage, insurance sales and underwriting, real estate brokerage and relocation services, and mortgage loans. The consolidated assets of The Prudential totaled $164 billion at year-end 1989.

- **American Express**, the largest domestic financial firm (based on market capitalization), owns Shearson Lehman, the second largest securities firm; one foreign bank, three domestic banks -- including Boston Safe Deposit and Trust Co. with over $9.7 billion in assets -- and two industrial loan corporations; and two insurance companies, Amex Life Assurance Company and IDS Life Insurance Company. American Express is the largest issuer of travel and entertainment cards and offers securities brokerage and underwriting, mutual funds, FDIC-insured deposits, financial planning, merchant banking, international banking and currency services, and life insurance sales and underwriting. The consolidated assets of American Express totaled $131 billion at year-end 1989.

- **Merrill Lynch**, the largest securities firm in the country, owns Merrill Lynch Bank and Trust Company, an FDIC-insured bank. Merrill Lynch offers FDIC-insured deposits, a wide range of securities services such as securities underwriting and brokerage, money market funds, mutual funds, and cash management services for both businesses and consumers, debit/credit cards, and retail and corporate lending. The Merrill Lynch Insurance Group, with assets of more than $12 billion, underwrites and sells life insurance and annuity products. The consolidated assets of Merrill Lynch totaled $68 billion at year-end 1990.

- **Sears**, one of the nation's largest retailers, is among the largest issuers of credit cards with receivables in excess of $26 billion; owns a nationwide mortgage banking company called Sears Mortgage Company; is involved in real estate brokerage through Coldwell Banker; sells and underwrites both casualty and life insurance through Allstate Insurance; underwrites and sells securities and mutual funds through Dean Witter, which has some 8,000 account executives and more than 2 million accounts; and owns four insured depository institutions including Sears Savings Bank (a savings and loan in California), Greenwood Trust (a CEBA grandfathered bank), Hurley State Bank (a credit card bank), and Mountain West Financial (an industrial bank in Utah).

- **Ford Motor Company**, the second largest domestic auto manufacturer, owns Ford Financial Services with total assets of $115 billion. Ford Financial owns First Nationwide Bank, FSB, one of the largest federally insured savings institutions in the country; Associates, the sixth largest finance company in the country; Ford Motor Credit, the third largest finance company in the world; and U.S. Leasing, one of the country's largest and most diversified organizations in equipment and facilities leasing. Ford Financial (through Associates) is in the top 10 issuers of credit cards, is among the largest mortgage originators, and is one of the top five consumer lenders in the country. While auto financing was originally the base of Ford's lending business, today some 60 percent of the financial receivables of First Nationwide, Associates and Ford Motor Credit are not auto related. Ford also underwrites and sells insurance through two insurance companies owned by Ford Motor Credit.

- **General Electric Corporation** owns General Electric Financial Services with total assets of $90.9 billion. GE Capital, the second largest finance company in the country, is one of the largest commercial lenders, providing corporate loans, asset financing, asset management, and real estate financing; GE Capital is the ninth largest issuer of credit cards (private label) with 2.5 million accounts. Employers Reinsurance is the second largest reinsurance company in the country. Kidder, Peabody was the largest underwriter of mortgage-backed securities in 1990, and was among the ten largest underwriters of debt and equity securities in domestic and world markets. And it has recently been disclosed that GE was interested in acquiring Goldome, a multi-billion dollar savings bank.

Tax Aspects of Expanded Products and Services

The Financial Services Holding Company provisions of H.R. 1505 would authorize affiliation of a commercial bank with a securities firm, a thrift institution, an insurance firm and a sponsor of a mutual fund--all as subsidiaries of the FSHC. There are several provisions of the Tax Code which treat commercial banks differently than the entities that would be affiliated with banks under H.R. 1505. Our objective today is to identify these key tax provisions as part of the Committee's consideration of level playing field taxation of competing financial institutions. We believe it is too early in this process to make specific legislative recommendations now, we urge that these issues be explored relative to the changes in the marketplace, especially if banking reform legislation is enacted.

Deductions for Losses - Banks, thrifts, insurance companies, securities firms and mutual funds all have separate and different rules for the timing of deductions for losses on their products. Since TRA 1986, banks with assets of $500 million or less can use the reserve method for bad debts under IRC Section 585, and larger commercial banks must use the specific charge-off method under IRC Section 166. In the case of those banks which can use the reserve method, the deduction for the reserve addition is based on a six-year moving average of actual loan losses. Thrift institutions and insurance companies can use a reserve method that is not limited to actual loss experience.

In determining whether these types of competing institutions should be treated differently for the timing of their loss deductions, it is appropriate to consider their actual loss experience. In the case of commercial banks the average loan loss experience has increased steadily to 1.42% of total loans in 1990. The changes in banks assets resulting from the market forces described earlier indicate that banks are often losing very good quality loan customers to the commercial paper market. Large corporations which are widely recognized for the reliability and stablity are able to borrow directly in the money markets and the experience in that market suggests that the loss to investors is quite low. Securitization of other types of bank assets (loans and leases) under the requirements and standards of the secondary market for such assets, suggest that this is another area in which the quality of banks' loan portfolios is declining. In short, the good loans can be sold off, leaving the bank with a higher percentage of risk loans.

Interest Expense related to Tax Exempt Income - The competing financial entities seem to be subject to very diverse rules. Banks suffer a 100% interest expense disallowance related to tax exempt obligations, with no review as to the purposes of the borrowing. The only exception is in the case of obligations of small issuers, a $10 million threshold. The interest on small issue obligations is, however, subject to the alternative minimum tax provision. In contrast, other taxpayers are subject to a subjective rule that looks at the purpose of the borrowing and requires tracing of the loan proceeds. The IRS may find it very difficult to enforce the subjective rule. (See report of the General Accounting Office, "Deducting Interest on Funds Borrowed to Purchase or Carry Tax Exempt Funds," December 1988). Moreover, Rev. Proc 72-18 provides a 2% of asset threshold that is not available to commercial banks or dealers in tax exempt securities.

The essence of the banking function is intermediation of borrowers and depositors, finding an investment home for the funds of a depositor who is not able to identify a good loan customer, and who is not prepared to efficiently bear the cost of the loan transaction or, more importantly, the risk of loss. As a result, it is virtually never possible to trace banking deposits to a particular tax exempt investment. Similarly, it is both conceptually and operationally impossible for a bank to trace some of its liabilities into specific taxable assets, which would allow the bank to wall off some of its interest expense from the impact of an across the board interest expense disallowance as currently exists under IRC Section 265(b). It is possible, however, that a securities firm may be able to isolate both a source and use of funds so as to avoid the interest expense disallowance. See, for example, Rev. Rul. 74-294 where interest paid by a securities firm on loans from commercial banks which are securitized by a customer's tax exempt obligations is not subject to the Section 265 disallowance.

Sale or Exchange of Debt Obligations -- Since 1969 commercial banks have been subject to ordinary gain or loss treatment on the sale of bonds, debentures, notes and other evidences of indebtedness under IRC Section 582(c). The basis for treating these instruments as ordinary assets rather than capital assets is that they are like inventory in the hands of commercial banks. This rule also prevented whipsaw of either the IRS or the taxpayer during the period when there was a preferential rate for capital gains. Section 582(c) only applies to commercial banks and thrift institutions. Ordinary treatment is also provided for dealers in securities in certain circumstances under IRC Section 1236. The FSHC proposal might cause a tax concern by authorizing affiliation of some firms which have ordinary treatment and some which have capital treatment on these exchanges.

The broad language of the Supreme Court decision in the case of Arkansas Best v. Commissioner, 485 U.S. 212 (1988), has clouded the question of character on the sale of many financial instruments. We believe Congress should clarify the state of the law on the sale or exchange of certain financial instruments that had previously relied on the Corn Products doctrine. Indeed, the ABA has previously testified before this committee [1] that Section 582(c) should be amended to provide for ordinary treatment in the case of the sale or exchange of shares in a bond mutual fund and in the case of sale or exchange of financial instruments for asset and liability hedging purposes. Clearly those transactions are "ordinary" activities in the case of a financial institution, whether it be a commercial bank or other entity primarily engaged in providing financial services. An IRS Coordinated Issue Paper holds that sale or exchange of property received through foreclosure or securities received as part of a loan workout or debt restructuring is subject to ordinary gain or losses, unless the bank took some clear action to shift the property to an investment account. It is our understanding that the conclusion still holds even after the Arkansas Best decision.

Financial Products -- In addition to the Committee's inquiry into the taxation of the corporate entities, there should be an inquiry into the taxation of financial products offered by the competing financial institutions which operate in the U.S. and global markets. In general, we believe that most products are taxed under the same rules, regardless of the charter of the entity providing the service. In the past, however, some bankers viewed single premium life insurance as competition for bank savings instruments, and expressed concern that these policies were supported by tax benefits unavailable for bank CDs or even IRA deposits. In light of the proliferation of new financial products available in the marketplace today, we believe it would be very useful for the Committee to explore whether income from these instruments is treated in the same manner in the hands of commercial banks, investment banks, insurance firms, etc.

Bank Common Trust Funds -- Section 245 of H.R. 1505

Treasury's proposal would permit a common trust fund to be converted to a mutual fund without triggering the consequences of a sale to the trust and its participants. A bank common trust fund is a vehicle for the combined investment of trust accounts held by a bank as trustee, administrator, executor, guardian or custodian under the Uniform Gifts to Minors Act. The collective investment of these fiduciary accounts allows each account to achieve investment diversification and creates efficiency of administration which would not be available if each account were handled separately. These funds are comprehensively regulated by the Comptroller of the Currency whose rules apply even for state chartered banks. They are also subject to the limitations of IRC Section 584. At the end of 1989, banks operated 2,033 common trust funds aggregating more than $100 billion.

Currently, both the Securities Act and Investment Company Act provide exemptions for common trust funds that are maintained exclusively for the collective investment and reinvestment of assets banks contribute in their capacity as trustee, executor, administrator or guardian. The Securities and Exchange Commission has consistently interpreted the common trust fund exemptions in both these statutes narrowly to apply only when underlying trust relationships are created for "bona fide fiduciary purposes". Advertisement of a common trust fund outside the promotion of the bank's general fiduciary services according to SEC staff, is an indication that the fund is established primarily as a vehicle for money management and therefore, is not exempt from registration.

Treasury's bill narrows the statutory exemption for common trust funds from the definition of Investment Company in the Investment Company Act of 1940. Should a bank fail to meet the conditions of the exemption, registration under the '40 Act would be required. Investment companies are taxable under Subchapter M of the Code which accords similar, but not identical treatment. ABA believes the spirit of the Treasury proposal requires treating all registered funds the same. New Section 584(h) would permit transition of the fund to Subchapter M without penalizing fund participants.

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[1] Testimony of Paul Claytor before the Subcommittee on Select Revenue Measures, October 26, 1989.

For relatively small common trust funds registration under the Investment Company Act is a very expensive proposition. The vast majority of common trust funds are smaller than the $100 million level generally accepted as the size needed to make a mutual fund economically viable. In fact, approximately 1700 of the 2,033 funds consist of assets of under $75 million.

The thrust of the Treasury proposal is to permit banking institutions to compete on an equal footing with other financial institutions. We believe the decision to maintain a common trust fund or to register it under the Investment Company Act and become a mutual fund should be an option for each bank to make in accordance with its fiduciary responsibility to the trust account. The Treasury bill would give a bank protection in that if it meets the standards as provided it could be assured that registration is not required.

Revenue Impact -- The Treasury bill provides that this conversion would not be considered to be a taxable event for the participating trust. We are informed that the Service is hesitant to rule that a conversion from a bank common trust fund to a mutual fund would not be considered a sale of the common trust fund's assets to the mutual fund and thus such a transaction would subject the participants to capital gains tax. The possibility of such treatment has caused banks not to go forward with such a conversion because subjecting a fund's participating trusts to this tax consequence, absent significant other benefits, would likely violate the bank's fiduciary responsibility.

It is our impression that this provision would cause no revenue loss because, as stated, banks would be unwilling to cause this tax effect. A bank may make the decision to convert to a mutual fund for a variety of reasons. Bank common trust funds may not be made available to IRA accounts, or to other non-trust accounts over which the bank has investment responsibilities. Yet bank customers have continually expressed a desire for bank investment management. Only through collective investment can smaller sums be invested efficiently and economically, and only through collective investment can diversification of small sums be achieved.

Rather than have a proliferation of collective vehicles with similar investment objectives, it makes sense for a bank to operate a single vehicle, provided the appropriate regulatory structure is in place and the obligations to customers are adhered to. Such a decision to convert to a mutual fund is one that would be made most carefully by bank trust departments. A bank trustee is subject to strict fiduciary standards and must be shown to be in the participant's best interests. Once a common trust fund makes the conversion and becomes registered it can than be marketed by advertising its investment performance to an unlimited universe of potential customers. The bank would no longer be limited to participants in which the bank acts as a fiduciary. The participants would benefit from the decision to convert as the cost of maintaining the fund would be spread over a much larger number of participants. Functional regulation, as envisioned in the Treasury bill would be in place.

Taxpayer Identification Number's for Bank Depositors -- Section 101(b) of the Bill

The deposit insurance reform provisions of the proposed legislation would require that all deposits be registered under the taxpayer identification number or employer identification number of each depositor. It appears that the purpose of this provision is to ensure that the $100,000 limit on deposit insurance per depositor per institution will be properly enforced. We urge this Committee not to expand this banking law proposal into the tax law provisions governing information reporting, backup withholding and the related penalty provisions of the Code. Currently, for tax information reporting purposes, under IRC Section 6049, financial institutions are required to obtain and report the TIN or EIN of only the accountholder listed first on the account, which information is used for IRS document matching.

TAXATION OF COMPETING DEPOSITORY INSTITUTIONS

As described earlier in my testimony, the Committee has correctly recognized that the sources of competition to commercial banks for offering of financial services has changed. Multifaceted firms made up of insurance companies, securities firms, finance companies and mutual funds are growing competitors. Nonetheless, we believe that the Committee's inquiry into the "level playing field" issues would be incomplete without consideration of tax issues affecting some traditional competitors as well, specifically, (1) the special bad debt reserve for thrifts under IRC Section 593 and (2) the tax exemption for income earned by credit unions under IRC Section 501(c)(1) and (c)(14).

Thrift Institution Reserve for Loan Losses

In previous testimony before this Committee[2], the ABA urged the Committee to review the special bad debt reserve provision for the savings and loan industry, especially in light of changes in the supply of funds to finance home ownership. The bad debt reserve for thrifts, which is far in excess of their loan loss experience, has **not** served to encourage S&Ls to maintain their specialization in mortgage lending. In 1974, thrifts devoted 70.8% of their assets to direct holdings of residential mortgage loans, but even with the tax incentive, that number has now fallen below 45%. Indeed, the current tax provision actually encourages thrifts to reduce their committment to mortgage lending. Moreover, the development of the securitization of mortgage loans for resale in the secondary market is undermining the need for special purpose institutions devoted exclusively to mortgage lending. In contrast, commercial banks have been increasing their share of the mortgage market, so that now commercial banks originate more residential mortgage loans than thrifts. Commercial banks, however, get no tax benefit for making mortgage loans.

The Committee should review and revise the provisions of Section 593. We recommend that the Committee move toward a functional approach to taxation of financial institutions by considering applying identical tax treatment to all providers of housing finance. This change could be made either by striking Section 593, or by sharing the amount of the tax benefit among all of the institutions actually providing housing finance.

As the Committee reviews the thrift loan loss reserve rules, it should consider the treatment of reserve recapture. Savings banks that flunk the qualifying asset test related to Section 593 and thrifts which convert to a commercial bank charter fall out of the ambit of Section 593 and become subject to the commercial bank rules under Section 585. Those instutions with assets over $500 million will be subject to the reserve recapture rules of Section 585(c). We urge the Committee to consider the additional economic hardship that would be visited on these thrift institutions if they were required to recapture the reserve in a short time frame. It may be time to smooth the transition of thrifts to commercial banks. Presently both the tax and accounting treatment governing recapture by such institutions effectively preclude them from making the otherwise prudent decision to covert to commercial bank status.

Tax Exemption for Credit Unions

The most blatant exception from fair taxation of financial institutions is the tax exemptions provided for federal and state chartered credit unions. Both the Carter and Reagan Administrations and the Congressional Budget Office proposed the elimination of this tax expenditure. The dramatic growth of credit unions in the last few years further underscores the need to eliminate the tax exemption for credit unions.

Prior to the 1970s, it might have been reasonable to conclude that credit unions were primarily small, volunteer-run, self-help institutions which had a limited charter, limited membership and were not really serious competition for taxable financial institutions. The credit unions are now a $200 billion industry providing diversified services to a wide array of customers. Credit unions' assets tripled in the 1980s, and their membership has grown to 60 million. Thirty-four percent of the adult population are members of credit unions.

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[2] Testimony of Thomas P. Rideout before the Committee on Ways & Means, March 9, 1989.

The sources of credit union growth are almost entirely due to government policy:

o The relaxation of the "common bond" has allowed credit unions to increase their membership base so that there is no significant difference in the market prospects between a bank and a credit union.

o The introduction of federal insurance for credit union deposits in 1971 eliminated the traditional financial linkage between credit unions and borrowers.

o Banking law changes in 1978 and 1980 expanded credit union services by permitting mortgage loans and transaction accounts. Now credit unions offer commercial loans as well.

o Exemption from federal income taxation has been an important influence in credit union growth. Two $25 million institutions, one a taxable bank and one a tax-exempt credit union having the same capital and the same pre-tax earnings will grow at different rates so that at the end of 10 years a credit union will be $133 million in size and the bank would be limited to total assets of $76 million.

The consequences of the exemption from federal income tax for credit unions are substantial, especially where they compete with a community bank of similar size. The exemption enables credit unions to offer a combination of lower prices on loan products and higher interest on deposits. The consumer market is more sensitive to the pricing of products and services, thereby responding to credit unions' tax advantage. Indeed, the sophistication of credit union customer base demonstrates that the tax subsidy largely benefits upper middle class persons, rather than lower income groups as is commonly believed.

Surveys by the Credit Union National Association and other groups show that middle-to-upper income groups are over represented among credit union members as compared to commercial banks. These surveys indicate that commercial banks, not credit unions, play a more significant role in providing financial services to lower income households. The above average income and professional status of the typical credit union member raises equity questions for the American taxpayer. Certainly the change in the size and market and powers of credit unions undercuts the rationale for continuing tax exemption for credit unions. Moreover, making credit unions taxable will increase revenues by several hundred million dollars each year, and prevent further erosion of the tax base by this growing industry.

CONCLUSION

ABA appreciates the opportunity to comment on both the debt management and tax aspects of the Administration's banking reform proposals. The changes we have recommend for immediate action relating to the NOL rules, the treatment of transfers of common trust funds, the tax benefit for mortgage lending and the taxation of credit unions, taken together, are likely to be at least revenue neutral. While the remaining issues we identified may not be ripe for enactment as part of H.R. 1505, we do believe that the Committee should study the issues raised today so that we can work towards fair taxation of competing and affiliated financial institutions. We pledge to work with the Committee and staff in developing these issues in the future.

Mr. GIBBONS. Thank you.
Mr. Kingman.

STATEMENT OF S. RUSSELL KINGMAN, MEMBER, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS (PRESIDENT AND CHIEF EXECUTIVE OFFICER, BRIDGEWATER SAVINGS BANK, BRIDGEWATER, MASS.)

Mr. KINGMAN. Good afternoon, Mr. Chairman.

My name is Russ Kingman. I am president and CEO of Bridgewater Savings Bank in Bridgewater, Mass. This is a $95 million mutual, State-chartered, profitable and tax paying savings bank.

I am appearing here today on behalf of the National Council of Savings Institutions, a trade association of approximately 350 members, and savings banks, cooperative banks, and savings and loan corporations with approximately 4,000 branches across America. I welcome the opportunity to testify this afternoon on H.R. 1505.

My $95 million institution competes in a marketplace with credit union competition as follows. Within 15 miles of my front door I have over $1 billion of credit unions. Within 25 miles I have $2 billion of credit union assets I compete with, all of which is in what I call the second credit union industry. The first credit union industry has the well-defined common bond located within the walls of a church or factory, in which it was formed. It frequently has volunteer help and a limited menu and generally fits the definition of the credit union movement. The second credit union industry is the one I will address today. They are big, out on Main Street, very lavish quarters, common bonds that frequently are a charade, large ad budgets, professional staff and product line that equal and sometimes exceeds the tax paying community banks with which they compete.

The credit union industry as a whole grew from $18 billion in assets in 1970 to approximately $200 billion today, and much of that growth came in what I am referring to as the second credit union industry.

One of the credit unions I compete with has grown from approximately $35 million to $225 million in assets in just 5 years. Last year they reported net income of over $1.7 million and paid no taxes, State or Federal.

Another credit union I compete with has also had an outstanding growth and is now $295 million in assets. Last year they reported net income of over $2.3 million and paid no taxes, either State or Federal. I have distributed through the office some pictures of these credit unions which I hope, Mr. Chairman, that perhaps you and other members of the committee might look at. By way of comparison, my bank earned $309,000 last year, and out of that paid $148,000 in taxes.

Summarizing, the two biggest credit unions I compete with earned over $4 million and paid nothing while I earned $309,000 and paid $138,000 in taxes. I ask, is this fair or is it economic?

One of the things frequently missed in this picture is credit unions have become the fastest growing segment of the financial services industry and while they should with their tax subsidy. As a bigger part of the pie becomes nontaxable, another part of the pie, that which competes with it, earns less and less because of the necessity of competing with higher deposit rates and lower loan rates. Therefore, we continue to pay less taxes. The Government loses on both counts.

Mutual savings bank and cooperative banks used to be tax exempt as well. In the 1950s the determination was made they deserved to be taxed on the same basis as their competitors. We make the proposal that the second credit union industry has long since come of age and is entitled to similar taxation.

Our proposal is that any credit union over $25 million in assets be taxed on the same basis as community banks. By choosing the $29 million figure, we have essentially exempted approximately 90 percent of the credit unions in this country.

But the 10 percent, the 10 percent that I term the second credit union industry, controls a majority of the credit union assets. The tax revenues that that 10 percent might generate I have seen estimates all the way from $2 to $5 billion over 5 years. I am not in position to tell you which one of those figures is correct.

Last, as I walked up the hill here to this building, I passed the Sam Rayburn Building. Out in front is a statue called "The Spirit of Justice." I would like to suggest today that "The Spirit of Justice" for the community banks in this country is such that it dictates fairness in the taxation issue with a second credit union industry.

I would ask this committee and this Congress to adopt that taxation so that we might all compete on an equal playing field. I would also suggest that you schedule that taxation over a 3-year period, a 3-year phasein period. That way each credit union that is affected by this will pay one-third of its normal taxes the first year, two-thirds the second, and the entire bill the third. It will provide for a phasein period so they can get used to doing what the rest of us have been doing all these many years.

Thank you, Mr. Chairman. I will answer any questions you may have.

[The prepared statement follows:]

TESTIMONY OF S. RUSSELL KINGMAN

ON BEHALF OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

BEFORE THE COMMITTEE ON WAYS AND MEANS

OF THE U.S. HOUSE OF REPRESENTATIVES

MAY 29, 1991

Good morning, my name is Russell Kingman, and I am President and CEO of Bridgewater Savings Bank, Bridgewater, Massachusetts, a $95 million mutual, state-chartered, profitable and tax-paying community savings bank, insured by the Bank Insurance Fund (BIF). I am here today representing the National Council of Savings Institutions, a trade association of approximately 350 BIF-insured savings banks and cooperative banks, and savings and loan associations. National Council members have over 4,000 branches nationwide. The National Council welcomes this opportunity to testify on H.R. 1505, The Financial Institutions Safety and Consumer Choice Act of 1991, ("the Bill"), which was introduced by Chairman Gonzalez and Mr. Wylie of the Committee on Banking, Finance and Urban Affairs. The Bill was introduced at the request of the Administration and is the Administration's proposal to recapitalize BIF, revise the system of bank regulation and insurance, and expand the activities in which banks are permitted to engage.

I intend to address two topics on which the Chairman has requested testimony in connection with the Committee's consideration of the Bill -- the continued feasibility of current tax provisions applicable to banks and other competing financial institutions and the BIF recapitalization plan. With respect to the first topic, there are two tax provisions that impede the Bill's goals of increasing competition among financial intermediaries and rationalizing the rules regulating depository financial institutions -- the provision that makes credit unions tax-exempt and the provision that imposes a tax penalty on thrift institutions converting to commercial bank charters.

Large Credit Unions Should No Longer Be Tax-Exempt

The Bill represents the most recent addition to a series of legislative and regulatory actions that has increased steadily competition among depository financial institutions and between depository financial institutions and other financial intermediaries. Recent tax acts, which have been part of this pattern, have significantly cut back or eliminated the tax advantages formerly enjoyed by depository institutions. For example, as a result of the Tax Reform Act of 1986, the use of the reserve method has been eliminated or curtailed, interest incurred on tax-exempt obligations is no longer deductible, and the treatment of net operating losses has been changed. The effect of these changes in the tax laws is that depository financial institutions, with one exception, are subject to approximately the same effective rate of tax as other domestic corporations. The glaring exception is, of course, credit unions. In the case of all other financial intermediaries, along with the gradual blurring of the distinctions in their business activities, has come a loss of their unique tax breaks. Credit unions, however, have grown in terms of both services and membership, to a $200 billion industry that is now in direct competition with other depository institutions yet remain tax-exempt.

Credit unions were first established in the U.S. in 1909. They grew slowly for the first 60 years of their existence. Between 1970 and 1988, however, assets in credit unions grew phenomenally, from less than $18 billion to almost $200 billion. Today, membership in credit unions exceeds 60 million; 34 percent of the adult population of the U.S. belong to credit unions.

Credit unions were founded to extend short-term personal loans to members of a narrowly defined group. The "common bond" uniting credit union members was often a common employer or membership in a common local organization. Prior to the establishment of federal insurance for credit unions in 1971, the common bond was perceived by most members as crucial, because the safety of individual deposits depended directly on borrowers' ability to repay loans. Federal insurance made it possible to loosen the definition of common bond. In general, from 1972 onward the categories within the definition have been so expanded that it is virtually meaningless as a concept, and certainly not a meaningful restriction on the size of the membership of most credit unions. The reality of the common bond restriction today is that a typical credit union is free to compete for the same pool of potential members as a community bank. And I want to emphasize that I am not comparing credit unions to Bank America or Citicorp, but rather to the thousands of smaller community banks, such as mine, across this nation.

The expansion of financial services at credit unions began in 1978, when credit unions were authorized to offer mortgage loans. In 1980, credit unions were authorized to offer transaction accounts. Today, many credit unions offer a full range of financial services similar to those at any community bank -- real estate loans, credit cards, debit cards, IRAs, student loans, consumer loans, home equity lines of credit, even agricultural and commercial loans. This full range of services, combined with a relaxed definition of common bond, makes many credit unions virtually indistinguishable from community banks. The fact that many credit unions function just like community banks and are in direct competition for depositors and customers requires a reevaluation of their tax-exempt status. Because credit unions are exempt from federal (although not necessarily state) income taxation, they have a significant and unfair competitive advantage. Credit unions pay no tax on their retained earnings and, in turn, the interest generated from these retained earnings is tax-free. Their lower cost of funds enables credit unions to pay higher interest on deposits and to charge lower rates on loans. It seems apparent that, while the rapid growth of credit unions may have been facilitated by federal insurance and the stretching of the common bond, it was made possible by their ability to compete as tax-exempt entities.

Within 15 miles of my front door, I compete with over $1 billion dollars in assets of community-based credit unions. Within 25 miles, I estimate there are $2 billion in credit union assets. One of them, the $220 million Bridgewater Credit Union, has grown from $35 million in assets to $220 million in assets in approximately five years and last year reported $1.7 million of tax-free income. The Brockton Credit Union, now a $295 million institution, has also had an outstanding growth rate, and last year, with assets of $295 million, reported a net income of $2.3 million and also paid no taxes. My bank, with $95 million of assets, reported gross income of $309,000 and paid federal and state taxes of approximately $148,000. By not taxing credit unions, the federal government loses two ways. First, the credit union industry's rapid growth means that a larger and larger share of the financial services pie is becoming tax-exempt. At the same time, our net interest margin has shrunk dramatically by having to compete with these tax-subsidized credit unions. This phenomenon means that an increasing share of the financial services pie is becoming tax-exempt and less taxes are being collected from community banks such as mine. The federal government loses on both counts.

The tax-exempt status of credit unions is not just unfair to other depository institutions, however, it is unfair to all taxpayers who must pay for their subsidy, but who cannot or choose not to join credit unions. It is an unfairness that is exacerbated, moreover, by the fact that, according to several surveys, credit union members, on average, earn more than the rest of the population. For example, according to a demographic survey done in 1987 by the Credit Union National Association, 48 percent of credit union members who responded had annual incomes between $30,000 and $80,000, as opposed to 32 percent of the nonmember respondents. On the other hand, 16 percent of the member respondents to the same survey had annual incomes under $20,000, compared to 28 percent of the nonmember respondents. It is difficult to justify the subsidization by all taxpayers of the borrowings and income of a group whose members happen to be more affluent than the average citizen. In fact, the 1984 Treasury report to the President on tax reform (Tax Reform for Fairness, Simplicity, and Economic Growth, (November 1984)) and the Bradley-Gephardt tax reform proposal (S.409 and H.R. 800) both recommended repealing the tax exemption of all credit unions. The National Council is not proposing, however, that all credit unions should lose their tax exemption. Those credit unions that have continued in their traditional role serving small, well-defined groups should continue to be tax-exempt. But we believe that there is no valid tax policy reason to continue the tax-exempt status of those large credit unions that compete head-to-head with community banks.

Large credit unions, in fact, are functionally no different from mutual thrift institutions. According to the April 10, 1990, American Banker, a North Carolina official was encouraging mutual savings and loans to resolve their capital problems by becoming credit unions. He stated that "the philosophies of credit unions and mutual thrifts are fairly similar." (Indeed, the tax exemption for credit unions was originally granted by reference to the tax-exempt status of mutual thrifts, but thrifts became taxable technically in 1951, and effectively in 1962.) At least one credit union has tried to buy a savings and loan from the RTC. The Patelco Credit Union wanted to buy the failed Peninsula Federal Savings Association in California and simply convert the deposit accounts to membership. A principle reason was that the savings and loan had a sizeable first mortgage-servicing portfolio and the credit union wanted to expand its mortgage-servicing business. In fact, the FDIC Banking Review in the fall of 1990 summarized "An Overview of the United States Credit Union Industry" by saying, "The U.S. credit union industry has evolved from serving simple, short-term consumer savings and lending needs, to being full-service consumer banks. Much of this change has occurred only in the last decade and coincides with a period of rapid change and increased competition for all financial institutions." The $400 million Digital Equipment Federal Credit Union could offer every banking service that a bank could offer.

President Reagan's comprehensive proposal to Congress for tax reform (The President's Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985)) would have eliminated the tax exemption for credit unions with total assets of $5 million or more. The 1989 American Bankers Association study on credit unions stated, however, that the "bulk of bank/credit union competition takes place" with $10 million or larger credit unions. Making credit unions of this size taxable would still leave 80 percent of all credit unions tax-exempt. The Joint Committee on Taxation and the Congressional Budget Office have both estimated that taxing all credit unions or credit unions over $10 million would raise approximately $3.4 billion over the next four years. In fact, however, there are really two distinct credit union industries in existence today. There are those who continue to adhere to a narrow common bond, operate with volunteer help, and function in the basement of a church, a backroom in a factory, or similar such surroundings, and offer a limited product line. The second credit union industry is the ones who now have professional staff and product lines virtually identical to the community banks, and operate from expensive buildings with lavish advertising budgets. As noted earlier, they serve a clientele whose average income exceeds that of customers of the community banks.
Notwithstanding the fact that numerous studies have called for the taxation of all credit unions, the National Council is today making a new proposal. We are proposing that only when a credit union exceeds $25 million in total assets should it lose its tax exemption. If we use the $25 million of assets as the cross-over point into taxability, approximately 90 percent of all credit unions will remain tax exempt; only 10 percent of the credit unions, those in what I have termed as the second credit union

industry, would be taxed at rates equal to other banking organizations. Such credit unions function as full-service depository institutions that have stretched the common bond beyond its elastic limit and indeed beyond any reasonable limit. The concepts of efficient resource allocation and tax neutrality require that the second credit union industry compete on a level playing field with community banks, with no tax subsidies.

Recapture of Thrift Bad Debt Reserves

Many profitable and well-capitalized savings and loans wish to convert to a commercial bank charter. FIRREA and the subsequent actions of the banking and thrift regulators have removed many of the barriers to such conversions. Proposals that are currently being considered for inclusion in the Bill would continue to facilitate this natural evolution. Nevertheless, a significant barrier to charter conversions remains unaffected in the Internal Revenue Code -- the reserve recapture rules. Because these rules function as an absolute barrier, in most cases, to savings and loans and savings banks that wish to function as commercial banks, they are a source of insignificant revenue. The reserve recapture rules function only as an unwarranted intrusion by the Code into the regulation of thrift institutions. In fact, they are inefficient at regulating financial activities because they affect only profitable and well-capitalized institutions and have no effect at all upon those that have nothing to lose by taking risks.

The Tax Reform Act of 1986 amended section 585 of the Internal Revenue Code, which provides the rules by which banks compute the additions to their reserves for bad debts. Subparagraph 585(c) was added to require that all "large banks" (over $500 million in assets) change from the reserve method of accounting to the specific charge-off method. "Small" banks ($500 million or less in assets) were not affected by the Tax Reform Act changes. They are permitted to continue on the reserve method, so long as they remain small, making additions to their reserves under the "experience method" of section 585(b)(2). This method of computing reserve additions uses a rolling six-year average of actual bad debt experience. Taxpayers changing from the reserve method to the specific charge-off method must recapture their reserves (include them in income) to prevent them from receiving a double deduction -- once when the additions to the reserves were made, and the second time when the loans are actually charged-off against income. Paragraphs 585(c)(3) and (4) provide the two exclusive timing rules for the recapture of the reserves of large banks. Paragraph 585(c)(3) (the "direct inclusion method") provides that large bank reserves shall be taken into income at a progressive rate over four years. The "cut-off method" of paragraph 585(c)(4), on the other hand, provides that no further additions may be made to the reserves so that they will gradually be drawn down as the loans outstanding at the date of the change are charged to the outstanding reserve balance.

Section 593 of the Code, which provides the corresponding methods of computing reserve additions for thrifts, was also amended by the Tax Reform Act. As a result of this amendment, all thrifts -- savings banks, as well as savings and loans -- must satisfy section 7701(a)(19)(C) of the Code to be eligible for section 593. Subparagraph (C) states that in order to satisfy the definition of a "savings and loan," 60 percent of the institution's assets must be "qualifying assets" (home mortgages and certain other assets). Prior to the Tax Reform Act, it should be noted, savings banks could continue to compute their bad debt reserve additions under section 593 even if they failed the 60 percent qualifying assets test. They were just not entitled to use the percentage of taxable income method to calculate their reserve additions until they satisfied the 60 percent test. Since 1969 the methods of computing reserve additions under section 593 have been the same as commercial banks' -- except for the "percentage-of-taxable-income" method. Thrifts that meet the qualifying assets test are entitled to use the percentage-of-taxable- income method, which -- at least prior to the Tax Reform Act -- provided generous reserve additions unrelated to any history or expectation of loan losses. A thrift that loses its eligibility to compute its reserve additions under section 593 (by changing its charter, in the case of a savings and loan, or by diversifying its investments, in the case of a savings bank) becomes a "bank" subject to the provisions of section 585. Thus, if an institution that loses its eligibility for section 593 has over $500 million in assets, it will treated as a large bank and be required to recapture the entire amount of its reserves. If it has $500 million or less in assets, it will be permitted to remain on the reserve method as a small bank.

There was widespread opinion that it was unfair for the Tax Reform Act to require large thrifts that lose eligibility for section 593 to recapture the excess of their reserves over the amount they would have built-up as banks, that is, the amount of their qualifying loan reserve attributable to reserve additions using the percentage-of- taxable-income method. This "excess reserve" has been considered a subsidy that was earned by the thrift industry for having made home mortgage loans and that should not have been made subject to recapture. For example, President Reagan, in his 1985 proposal for comprehensive tax reform, would have limited reserve recapture for thrifts to the same amount that banks were to be required to recapture. "The portion of the thrifts' tax reserves in excess of what they would have taken under the commercial bank method is not brought back into income because it was a special subsidy for investments in residential mortgages" (The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (May 1985), page 242). Although the Joint Committee on Taxation's own pamphlets speak of the excess reserve additions attributable to the percentage-of-taxable-income method as a "subsidy," the view has been expressed by Committee staffers that recapture of the excess reserve is justified because it was a tax-free build-up of capital made available to thrifts to meet their capital needs. In this view if a thrift changes its charter, it is appropriate to require recapture, apparently because the special needs no longer exist. I am not sure that this distinction between an unrestricted subsidy and subsidized capital is meaningful because all tax subsidies represent capital additions. There is a mismatching caused, however, by accounting for amounts that are properly included in a general reserve as a bad debt reserve. In very many cases the capital accumulated by thrifts through deductions for excess reserve additions has been used up by operating losses created by disintermediation -- the realization of the interest rate risk that theoretically always existed for institutions borrowing short and lending long and that was the basis for the subsidy in the first place. Because this subsidized addition to capital was accounted for tax purposes as a bad debt reserve, however, it was not offset by the operating losses it was created to absorb.

Another opinion has been voiced that it would be unfair to commercial banks if thrifts were permitted to become commercial banks without their excess reserves being taxed. These new commercial banks, this opinion holds, would have a competitive advantage because of the subsidized capital they accumulated as thrifts. My only problem with this view is that it ignores the fact that commercial banks were granted the same kind of tax-free capital and yet their subsidy will never be subject to recapture. For years commercial banks were permitted to zero-out their tax liability by investing in tax-free municipal bonds and taking a deduction for the portion of this interest paid out to their depositors. This tax benefit was ended by the Tax Reform Act, but no recapture will be imposed on the banks' tax-free capital. In the same way the tax-free build-up of capital that was permitted to thrifts was also virtually ended in 1986 by the reduction of the percentage-of-taxable-income deduction to eight percent in conjunction with the reduction of the overall tax rate. The difference is, of course, that the thrift industry's tax benefit remains subject to recapture because it was fortuitously accounted for as a reserve. This distinction -- that the thrifts' tax benefit was accumulated in the form of a reserve and the commercial banks' was not -- seems to me to be a technicality. To impose recapture on one group of institutions and not the other based on this technicality seems to me to be unfair. Tax policy should not be based on such technicalities. Instead, it should be based on the equities and economic realities.

In terms of the equities, how should the law deal with the fact that the banks are not to be required to recapture their tax-free capital, while the thrifts are being pushed by current banking policy to the point where current tax law will require them to recapture theirs? If the banks were to be required to recapture the fifty years of tax benefits they received by investing in tax-free bonds, many would be declared insolvent because they would lose so much capital. There are two groups of institutions that are now being forced to compete head-to-head -- both groups have been given tax-free capital, but now one group is to be forced to give back its capital. This is the real unfairness. The economic reality is that thrifts are being pushed by current banking policy to become commercial banks and yet if they do so, the current tax law could put them out of business. The recapture tax liability could result in an immediate loss of as much as one percent of a thrift's capital. For the typical thrift struggling to meet its 1.5 percent core capital requirement, the loss of this much capital would make it a candidate for RTC supervision.

The loss of capital results from the fact that the Tax Reform Act created both a tax and an accounting problem for large thrifts that lose their eligibility for section 593. The tax problem (coming up with the cash to pay the tax) was mitigated by the generous deferral provided, in effect, to large thrifts under one of the recapture timing rules. In fact, if the actual payment of tax were the only adverse consequence of a large thrift's decision to give up the reserve method, some of them might feel there is no need to change current law. Under the cut-off method of paragraph 585(c)(4) recapture does not begin until the" pre-change" loan portfolio has been reduced by dispositions below the level of the reserve. In any year that the reserve exceeds the outstanding pre-change loans, the excess is recaptured. Because of the long-term nature of a large thrift's loan portfolio, recapture under the cut-off method conceivably may not begin for 15 or more years after it goes off the reserve method, assuming it chooses not to restructure its balance sheet. No corresponding remedy exists, however, for an accounting problem created by the recapture provisions that is unique to thrifts. Under GAAP, thrifts have never been required to accrue deferred taxes (provide for recapture) on the excess of their tax reserves over their reserves. When a large thrift is disqualified from using the reserve method, the entire amount of the recapture tax attributable to the difference between the book and tax reserves must be reported as an expense of the current period. Thus, the potentially generous deferral of the actual payment of the recapture tax may do a large thrift little good. The thrift will be required to immediately reduce its capital by the amount of the tax on the difference between its book and tax reserves. In the case of an established and historically profitable thrift, this difference could be very large.

In 1989 a bill was introduced by Senator Moynihan that would have helped to relieve the capital loss problem created for a large thrift that loses eligibility for section 593. The bill -- section 6622 of the Revenue Reconciliation Act of 1989 (approved by the Senate on October 13, 1989) -- was passed by the Senate and accepted by the House tax conferees in the revenue reconciliation process. Section 6622 provided an election for a large thrift to recapture a smaller reserve amount -- the bank experience portion -- upon losing eligibility for section 593. But because this smaller amount would be recaptured much faster than under the cut-off method -- over four years under the direct inclusion method of paragraph 585(c)(3) -- the Joint Committee estimated that it would raise $47 million estimated. The remainder of the the large thrift's reserves would have remained outstanding subject to recapture under the rules of section 593(e). Section 6622 had the support of important Banking Committee Members and staff, because of its importance in complementing the banking policies adopted in FIRREA. It was largely based on specific drafting and policy suggestions made by members of the Joint Committee staff and was similar to that staff's recommendation for a thrift recapture provision made to this Committee in September 1985. At some point during the process, however, the Chief of Staff of the Joint Committee became concerned whether it was good tax policy to permit a savings and loan to change to a commercial bank charter without incurring full recapture of its reserves. He decided to request a legal opinion from the IRS.

In a letter dated November 16, 1989, the IRS expressed the opinion that section 585(c) does not apply to large thrifts that lose their eligibility for section 593 -- with no analysis other than to state that: (1) it would be unfair to large banks and small thrifts if it did apply, and (2) the legislative history is silent. (A copy of the IRS letter is attached to my testimony.) The unfairness to large banks arises, according to the letter, from the fact that thrifts have relatively larger reserves than commercial banks. It is apparent, however, that it is not the size of the thrift reserves that creates the perceived unfairness. In fact, the size of the thrift reserves cuts against the unfairness the IRS perceives. The unarticulated unfairness that concerns the IRS arises from the long-term nature of a thrift's loans. As I previously mentioned, a large thrift may have a considerable period of deferral under the cut-off method before it must begin to recapture its reserves. It seems likely that, in the view of the IRS, the cut-off method is too generous when applied to an institution with a portfolio of mortgage loans as opposed to commercial loans. It is as if large thrifts are to be punished for having engaged in home mortgage lending by having section 585(c) denied to them. Corroboration for the view that the IRS has decided that it is bad policy to permit large thrifts to use the cut-off method is found in the letter's statement that it would be unfair to small thrifts changing to the specific charge-off method to permit large thrifts to use section 585(c). Like small banks, small thrifts that change to the specific charge-off method do not have the recapture timing methods of section 585(c) available to them. They will be required to recapture their reserves over six years on a straight line basis using the IRS administrative practices under section 481 of the Code. I wish to reiterate, however, that the cut-off method was created to mitigate the statutory recapture scheme. Under the statutory recapture scheme, large thrifts that lose their eligibility for section 593 are required by section 585(c) to recapture their reserves, but small thrifts are not.

Now, however, the IRS has repudiated the position that it took in the letter. Its position that section 585(c) does not apply to large thrifts was flawed not only technically, but strategically as well. The position that the IRS took in its letter is manifestly incorrect -- anyone who reads the statute can see that section 585(c) applies to large thrifts that lose eligibility for section 593. But the IRS was so intent on taking away the pro-taxpayer part of section 585(c) -- the cut-off method -- that they failed to realize that they were conferring a potentially much greater benefit on large thrifts -- the ability to remain on the reserve method after they became large banks. The IRS has now adopted the absurd position that they can pick and choose among the rules of section 585(c). They will reject the rules that they do not like and enforce the rules that they do like. Section 585(c)(1) says that large banks -- implicitly including large thrifts ineligible for section 593 -- are ineligible for the reserve method. There is nothing in the legislative history of the Tax Reform Act, however, indicating that Congress intended to deny the reserve method to large thrifts that become large banks. It just follows automatically from the fact that they have become "banks," as defined in section 585(a)(2), that are "large" as defined in section 585(c)(2). Contrary to its letter, the IRS is now willing to go along with this literal reading of the statute. The statutory scheme of section 585(c) then provides that a large institution that has lost its eligibility for the reserve method must recapture its reserves under either paragraph 585(c)(3) or (4). Just as there is nothing in the legislative history, as the IRS letter points out, to say that paragraphs (c)(3) and (4) apply to large thrifts, there is nothing in the legislative history to suggest that they do not. The IRS position, however, continues to be that these two paragraphs do not apply to large thrifts. The IRS has thus taken the position that the exact same words in the exact same statute have their natural meaning when they are adverse to the taxpayer and have some other meaning -- which the IRS is as yet unable to articulate -- when they provide relief to the taxpayer. The IRS position is not just that they can ignore the Joint Committee's "Blue Book" to the Tax Reform Act, as their letter states -- it is that they can ignore the statute.

The IRS letter took a second position that is applicable to small thrifts that lose eligibility for section 593. As I mentioned, there is no question that such institutions are permitted to remain on the reserve method using the computational rules of section 585(b). The letter states, however, that a 1985 revenue ruling (published, it should be noted, after this Committee completed its mark-up of the recapture provisions that were enacted in the Tax Reform Act) would be interpreted to require small thrifts that remain on the reserve method to recapture their excess reserves. In Rev. Rul. 85-171, the IRS held that the integration of the reserves of a thrift merging into a bank required a section 481 adjustment because the computations of reserve additions under sections 585 and 593 are, in the IRS' view, different methods of accounting. The amount and the timing of the section 481 adjustment were not specified in the ruling.

Many practitioners have always believed that Rev. Rul. 85-171 was incorrect. Their reasons for this belief included:

(1) Under pre-1987 law, which was being interpreted by the ruling, sections 585 and 593, rather than being separate methods of accounting, provided computational rules for financial institutions on the reserve method of accounting of section 166(c).

(2) More importantly, Rev. Rul. 75-445 and Rev. Rul. 79-123 hold that changes in computing reserve additions within sections 585 and 593, respectively, are not changes in accounting methods. It seems arbitrary then that changes among very different methods of computing reserve additions within the same code section are not treated by the IRS as changes of accounting method, but that changes between the identical experience method computations of sections 585 and 593 are.

(3) Regardless, it cannot be the change of code section described in Rev. Rul. 85-171 that distinguishes it from the two prior revenue rulings because commercial banks were required in 1969 to change from the percentage method of Rev. Rul. 65-92 to that of section 585(b)(2), and no recapture of their excess reserves was imposed.

(4) Several times, in fact, before the Tax Reform Act changes, thrifts and banks were required to change to less generous methods of computing reserve additions, and no recapture of the excess reserves was imposed. Moreover, the "base year rule" of subparagraph 585(b)(2)(B), which permit an institution with excess reserves resulting from a computational change to deduct at least its actual charge-offs, indicate an antithetical attitude on the part of Congress, prior to 1986, to recapture even in the form of a draw-down of excess reserves.

(5) The legislative history of the 1969 Tax Act, whose amendments were the subject of the Rev. Rul. 85-171, discussed the effect on a savings and loan of failing the 60 percent test. The only effect mentioned was the loss of eligibility for section 593; there was no mention of recapture.

Even if the theory of Rev. Rul. 85-171 were correct, it is apparent that Congress and the Joint Committee staff were simply unaware of it; otherwise they would have overruled the ruling for being inconsistent with the statutory recapture scheme. The imposition of recapture on small thrifts changing from section 593 to section 585 under the administrative practices of the IRS would be, under the same criteria used in the IRS letter, unfair vis-a-vis small banks and large thrifts. In addition, the adverse effect of the IRS position on the capital of many unsuspecting small thrifts that have diversified their investments relying on the general understanding of the operation of the recapture provisions will be severe.

Perhaps in response to criticism of the positions taken in the letter and subsequently, the IRS is apparently considering another new position -- one that would integrate both section 585(c) and Rev. Rul. 85-171 in the recapture of large thrift reserves. If this new theory is adopted, the recapture of a large thrift's reserves would be accomplished in two steps. Under this two step or bifurcation theory the IRS would be willing to recognize that a thrift upon losing eligibility for section 593 becomes a bank described in paragraph 585(a)(2) and is permitted to determine its eligibility to remain on the reserve method under the rules of section 585. It is not entirely facetious to say that under the bifurcation theory a large thrift that loses eligibility for section 593, undergoes two changes in accounting method in the time it takes its tax advisor to read the provisions of section 585. The first change in accounting method seemingly occurs because a large thrift must actually change to section 585 in order to determine under paragraph 585(c)(1) that it is ineligible to change to section 585. At this point, using the theory of Rev. Rul. 85-171 that changing from section 593 to section 585 is a change in accounting method entitling the IRS to impose a section 481 adjustment, a portion of the large thrift's reserves would be recaptured. The second change in accounting method then occurs because the large thrift, having changed to a method of accounting that it is not permitted to change to, must change to the method of accounting that it is required to change to -- the specific charge-off method -- with the rules of section 585(c) determining the timing of the recapture of the remainder of its reserves.

The amount of the section 481 adjustment to which small thrifts, and large thrifts under the bifurcation theory, are to be subject to is reportedly the difference between the actual reserve for qualifying assets and a hypothetical reserve for the qualifying assets computed using the experience method of section 585(b)(3)(A) for the most recent six years. There will be no offset for the tax benefits given up in the years the percentage of taxable income method was used (such as the reduction in the dividends received deduction). Nor will the base year rule be available to small thrifts to restore the qualifying reserve to its 1987 level. In the case of large thrifts, under the bifurcation theory, the remaining reserves (after reduction by the amount of the section 481 adjustment) will be subject to the recapture timing rules of section 585(c)(3) or (4). If the recapture timing rules of section 585(c) are to be completely unavailable to large institutions, on the other hand, the section 481 adjustment will be the entire amount of their reserves. In all cases, under the administrative practice of the IRS, the amount of the section 481 adjustment will be taken into income on a straight-line basis over six years. To the extent that the recapture timing rules of section 585(c) are unavailable to a large thrift, it would appear that the suspension of recapture for a financially troubled large bank under section 585(c)(3)(B) will also be unavailable.

With respect to section 6622 of the Revenue Reconciliation Act, the IRS letter was used to revise its revenue estimate from a $47 million revenue raiser to a $22 million revenue loser over five years. The Members continued to support inclusion of the provision, but the changed revenue estimate removed it from the category of "revenue raisers." As a result, it was technically outside the procedural agreement, even though the revenue loss was relatively small, and it was dropped from the Bill. Given the importance of section 6622 to the implementation of the bank and thrift regulatory policies adopted in FIRREA and being considered in the Bill, a $22 million revenue loss should not, in my view, prevent this important provision from being enacted. The National Council believes that this revenue estimate is an inaccurate reflection of the true costs and benefits of the provision. The earlier revenue estimate -- showing that the provision would actually raise revenue -- is in my view a more accurate reflection of the underlying economic facts. The narrow range of variation -- from a $47 million revenue raiser to a $22 million revenue loser, the fact that there is considerable uncertainty surrounding the empirical and legal basis on which the revenue estimate has fluctuated, and the fact that any revenue estimate is inherently subject to uncertainty, all indicate that revenue should not be the driving factor for this provision. Indeed, the basis on which the revenue estimate was changed is a highly questionable position taken by the IRS. The Joint Committee staff has indicated that it is bound to follow the IRS view, regardless of whether the Joint Committee agrees or disagrees with the IRS. Even if that convention is binding on the Joint Committee staff, I would ask the Committee to review the law and the IRS position. If it finds that the statute has been incorrectly interpreted, or if it finds that Congressional intent has not been followed, I would ask the Committee to redress the situation directly or communicate its views to the IRS.

With respect to the problem created by the IRS letter for "innocent bystanders" -- the small thrifts that may have acted in reliance on the general understanding of the recapture rules applicable to them -- a technical correction may be needed. By clarifying that small thrifts have no recapture as long as they remain on the reserve method, the law will be conformed to decades of clear administrative and legislative precedent and to the understanding that Congress had in 1986. This is appropriate since it is not an area for the IRS to be experimenting with questionable positions that could cause serious disruptions -- even if they are overturned by the courts. This technical correction should be revenue neutral because Rev. Rul. 85-171 was neither anticipated nor assumed as a source of revenue when the recapture provisions were enacted. To assign a revenue cost to this technical correction would be tantamount to requiring the Congress to pay twice for the same provisions.

BIF Recapitalization

The National Council believes it is crucial to recapitalize BIF to assure consumer confidence in the industry and to assure that funds are available to close insolvent institutions. Because bank failures are rapidly depleting the funds available in BIF, this proposal is clearly the element of the Bill that requires the most immediate attention. We believe that any recapitalization plan must start with a realistic assessment of the size and the causes of the problem, conform to generally accepted accounting principles, and use borrowings, if necessary, at the Treasury rate. In addition, any plan must specify how the borrowing would be repaid, because the manner in which BIF is recapitalized will have a significant impact on the ability of community banks to build their capital base through retained earnings and to attract outside capital. As we apply these points to the Bill, we find that there is still a range of estimates on the total amount of borrowing that will be needed by the FDIC. While estimating the amount is not an exact science and will depend upon the duration of the current recession and other factors, more information is needed so that we can assess how the plan will work. The Bill does not appear to incorporate any provision that would deviate from GAAP. Earlier this year, several proposals were discussed that involved the purchase of preferred stock from the FDIC and could well have resulted in the double counting of assets by BIF and individual institutions. Maintaining public confidence dictates that any plan should conform to GAAP. The Bill has structured the borrowing so that it will be at the Treasury rate. In any plan of this type where billions of dollars will be borrowed, the burden of repaying the borrowings will be great; thus, it is essential that interest costs be kept to a minimum.

We have two additional concerns about the Bill. At some point, ever-increasing deposit insurance premiums become counterproductive. Recently, BIF premiums have increased dramatically, and they will go to 23 basis points on July 1 of this year. BIF's needs will certainly generate pressure to raise this figure even higher, thus making it increasingly difficult for the industry to build capital through retained earnings and to attract new capital. While the 30-basis-point cap may prove reassuring to investors concerned that premium increases could become an unlimited call on the capital of the industry, it is important to note that assessments for individual institutions could substantially exceed this "cap" through the imposition of risk-based premiums. The National Council does not wish to see delays in the implementation of a BIF recapitalization plan. However, before any plan is adopted, we feel it is essential that there should be a full understanding of the impact of the plan on the Fund and on community banks in particular.

I thank you for giving us the opportunity to testify today and would be happy to answer any questions.

Attachment to Testimony of S. Russell Kingman
National Council of Savings Institutions

NOV 17 1989

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

NOV 16 1989

Mr. Ronald A. Pearlman
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Dear Ron:

This is in response to your recent request for information on our position with respect to certain changes in accounting method. Specifically, you asked about the tax treatment of the "non-experience" portion of the bad debt reserve of a thrift institution that changes from a reserve method of accounting for bad debts allowed under section 593 of the Internal Revenue Code. The issue is the appropriate application of Code sections 446, 481, and 585(c) in such a case.

As you know, Revenue Ruling 85-171, 1985-2 C.B. 148, deals with a change of this type. In this revenue ruling, a thrift institution that maintained a bad debt reserve under Code section 593 merged into a commercial bank that maintained a reserve under section 585. After the merger, the bank's original business and that acquired from the thrift were operated as an integrated commercial bank business. The ruling holds that the integration of the thrift's bad debt reserve computed under section 593 into the bank's reserve computed under section 585 resulted in a change in accounting method under section 446 and therefore a section 481(a) adjustment was required.

It is the Service's position that sections 446 and 481(a) require the same result when a single entity changes from a reserve method of accounting under section 593, either to the reserve method of accounting allowed under section 585, or to the specific charge-off method of accounting. We know of no reason to depart from the principle stated in Revenue Ruling 85-171.

Section 585(c), which Congress enacted in 1986, repeals bad debt reserves altogether for large banks. This section also provides special rules for such banks to follow when they are required to change from the reserve method of accounting for bad debts to the specific charge-off method. Under the special rules, a bank may either recapture its reserve over four years, or it may use a cut-off procedure. Under the cut-off procedure, the bank maintains its reserve for loans that it held when it became a large bank, but it makes no new additions to the reserve.

Since section 585(c) applies only to banks that are "large," within the meaning of section 585(c)(2), it can have no application to a "small" entity that changes from a reserve method of accounting under section 593 to the specific charge-off method. Thus, if a "small" entity changes from a reserve method of accounting under section 593, either to the reserve method under section 585 or to the specific charge-off method, the change is treated as a change in accounting method under section 446, and a section 481(a) adjustment is required.

A question has arisen as to the treatment of a "large" thrift that is disqualified as a thrift and therefore may no longer use a reserve method of accounting allowed under section 593. The question is whether such an entity may follow the special rules that section 585(c) provides for large banks changing to the specific charge-off method. Because of the differences between computing reserves under section 593 and computing reserves under section 585, allowing large former thrifts to follow the special rules of section 585(c) generally would have the effect of providing greater tax benefits to those institutions than to institutions that computed their reserves under section 585. Moreover, allowing large former thrifts to follow the special rules of section 585(c) would treat them more favorably than other thrifts and former thrifts that change to the specific charge-off method.

The General Explanation of the Tax Reform Act of 1986 suggests at page 556 that the special rules of section 585(c) should apply to large former thrifts. However, neither the statutory language of section 585(c) nor the legislative history of that section so provides.

In light of the absence of contrary evidence of Congressional intent, and in light of the inequities that would arise, we believe that large former thrifts may not follow the special rules of section 585(c) for the reserve amounts that you asked about. Regulations to be issued under section 585 will confirm the position stated in this letter.

Best regards.

Sincerely,

Fred

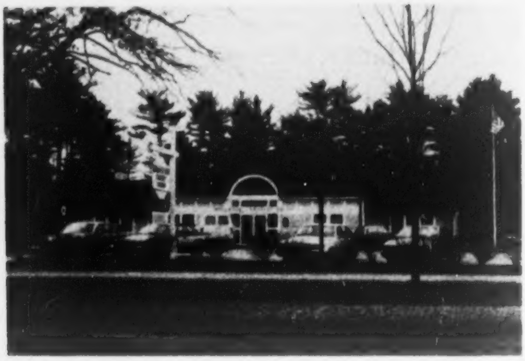
Fred T. Goldberg, Jr.

Home Office
BRIDGEWATER CREDIT UNION

Approximate Asset Size	$220,000,000
Estimated Construction Costs	$ 2,750,000

Branch Office
BROCKTON CREDIT UNION

Approximate Asset Size	$295,000,000
Estimated Construction Costs	$ 1,250,000



Branch Office
BROCKTON CREDIT UNION

Approximate Asset Size	$295,000,000
Estimated Construction Costs	$ 1,000,000

Mr. GIBBONS. Mr. Hughes.

STATEMENT OF THOMAS J. HUGHES, TREASURER, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS, AND MEMBER, CREDIT UNION NATIONAL ASSOCIATION, INC., AND AFFILIATES (PRESIDENT, NAVY FEDERAL CREDIT UNION, MERRIFIELD, VA.)

Mr. HUGHES. Thank you for this opportunity. I am president of the Navy Federal Credit Union in Merrifield, Va.

I am here today representing the Credit Union National Association and Affiliates and the National Association of Federal Credit Unions. We represent over 90 percent of the Nation's 15,515 credit unions and their 62 million members.

I appreciate the opportunity to present the views on a very limited number of credit union provisions contained in the bills, H.R. 1505 and H.R. 2094, which are the subject of this hearing.

These bills are primarily designed to recapitalize the Bank Insurance Fund and to make financial reforms to ensure a safe and sound financial banking system in order to avoid further burdens on the taxpayer because of serious problems in the financial system.

I hope our appearance here today serves to reassure you with respect to the credit union system. The credit union movement has taken several steps in recent years to modernize and reform our financial system. We worked to achieve an independent agency and Federal deposit insurance in 1970, modernized powers for credit unions in 1977, a three-member board and central liquidity facility in 1978, share drafts in 1980, and an innovative deposit-based pay-as-you-go system for fully capitalizing national credit unions share insurance fund in 1984.

Credit union members have been actively involved in a nationwide campaign to keep a separate and independent credit union regulatory and insurance system. Because of the changes and inherent less risky nature of credit union operations, the overall financial conditions of our system is quite good. This is in spite of the credit unions across the country being exposed to the same economic shocks that the rest of the financial institutions have been.

As an appendix to my statement, which I have submitted for the record, I have included a somewhat detailed summary of the overall conditions of credit unions and the National Credit Union Share Insurance Fund.

Mr. Chairman, my point in reviewing the overall health of our system is to contend that the taxpayer is best served by leaving the credit union system the way it is. Credit unions are not seeking new powers. There are no expanded business activities for credit unions in either H.R. 1505 or H.R. 2094.

There are two areas of concern to credit unions in Treasury bill H.R. 1505, however. Section 109 provides for expensing of our 1-percent deposit in the share insurance fund and expensing of each year's credit union growth adjustments to the share insurance fund and authority for NCUA to adjust the normal operating level of the share insurance fund.

Let me address the Treasury Department's concern. Overestimating credit union capital is the issue. We agree it is incorrect to merely add the equity and the shared insurance fund to the capital of the credit union movement to determine the total amount of taxpayer protection. The problem here is not that there is inadequate level of protection for the taxpayer, but rather that some observers may erroneously conclude there are more dollars than actually exist. If this is the case, it hardly warrants a major modification to our system which the 1-percent writedown principle would entail. A simple method of footnoting credit union balance sheets with respect to the amount of deposits in the share insurance fund should clarify the situation.

I note Secretary Glauber, in his submission for the record, spoke of four basic tenets that he felt the BIF should abide by. I would point out to the committee that credit union insurance funding already abides with those objectives. We strongly recommend against changing any aspect of the current deposit insurance fund NCUSIF.

Second, H.R. 1505, section 352 of the Treasury plan suggests changing the present NCUA board structure to provide one of three board members be the new Director of the Office of Depository Institutions Supervision, an official of the Treasury Department. We feel such a change would produce a serious imbalance away from the independent agency status deemed proper for NCUA and has worked. The current system worked extremely well in preserving a credit union regulatory and insurance system, which is aware of and sensitive to the differences between nonprofit cooperative financial institutions and the for-profit banking system.

I would like to deviate for a second in view of the previous comments and particularly those of Mr. Kingman of the National Council of Savings Institutions which I feel go well beyond the scope of the address of this hearing at this time. At any rate, I have to get a little bit personal of the things I am aware of.

Where Mr. Kingman suggests we ought to split the credit union system in two some way, large and small or some other way, that is a big problem as far as taxation goes. The whole credit union system works under the same philosophy. The Navy Federal Credit Union system was founded in 1933. It is the Nation's largest credit union. Mr. Kingman speaks to the largeness as being something wrong with it. In 1991 our assets are $5 billion and 1.1 million members. Our chartered field of membership is the Department of the Navy military, civilians, and their dependents, and we stick to our charter. Most of our 77 branches that we have—31 are overseas—have been established by the Department of the Navy's request. Seventy-five percent of them operated at a loss in 1990; 75 percent of those that we have overseas. Over half, 58 percent, did not contribute at all to the overhead of our operation, but we did not close them because we want to render that service to our people overseas. We operate around the clock telephone service to make loan applications and "savings rate throughout the world." We have a toll-free system within the country to handle savings and withdrawal requests. We charge the same interest rate for a given type of loan to all of our borrowers regardless of their net worth. There are no late fees charged on our loans. Delinquency rate is three-tenths of 1 percent, one of the lowest in the Nation. Our loss rate is 0.56 percent, similarly low.

Credit crunches like 1975 and 1980, we restricted loans quickly because we didn't have the savings to accommodate them. The things we restricted it to is loans for luxury items such as buying boats to take care of the common person of medium means.

We have no minimum loan amount. The average closed loan in 1990 was for $5,700. A study by the CUNA chief economist in 1990 found 44 percent of our consumer loans were for less than $2,000. The largest U.S. bank in the United States will not normally give a loan for less than $2,000 because they suffer a loss in the processing.

Our checking accounts are really free. There is no minimum balance or transaction charge. There are free blank checks. Our interest rates for our credit card is 14 percent with no annual fee. We operate a pilot program to guarantee payment of members' utility bills. These are sailors and marines in various places.

In the country when they move into an area they have to put up a large amount of money for downpayment or advanced payment on the utilities. We operate a system where we will provide that guarantee to the utilities and pay if they should happen to skip.

We stress member education. I would like to make a very significant point. We are not a high-roller organization, although we are large. The largest segment of our membership is enlisted personnel. They are 2½ times as large as the office of personnel we have.

Enlisted members outnumber the combined total of officers and Federal civilian employees by more than 25 percent. The second largest member category is our family members. The average balance in members' savings account is less than $1,500 and nearly half our members' savings accounts have balances of $100,000 or less. Twenty-five percent of them are $10 or less at month's end.

About half of our members have NFCU checking accounts and the average balance is $1,150. Forty-three percent have less than $100 in their checking account at the end of any given month.

Mr. Kingman pointed out that we should be taxed because we are the same. There should be a level playing field. But I would like to point out that I could go up and put savings in Mr. Kingman's organization, but I would not allow him to put savings in mine. He is not a member of our organization. He is not in our field of membership.

In summary, credit unions receive no expanded business activities under the provisions of H.R. 1505 or H.R. 2094, and no changes are proposed in the tax-exempt status of credit unions therein. I would concur this status should remain unchanged. This status was granted to credit unions on the basis that they are not-for-profit. They are member owned and run. They are cooperative in nature. They are directed by underpaid volunteers serving their chartered members, democratically operated under State or Federal regulations and different from banks in their underlying motives and basic approach to serve members.

I firmly believe credit unions are continuing to earn the status they presently have. I have submitted a more detailed written statement for the record. Subject to your approval, I would request it be put in the record.

I will be happy to answer any questions, Mr. Chairman. Thank you very much.

[The prepared statement follows:]

STATEMENT OF THOMAS J. HUGHES ON BEHALF OF NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS AND CREDIT UNION NATIONAL ASSOCIATION AND AFFILIATES

Mr. Chairman, members of the Committee, my name is Tom J. Hughes. I am President of the Navy Federal Credit Union in Merrifield, Virginia.

I am here today representing the Credit Union National Association and Affiliates and the National Association of Federal Credit Unions. We represent over 90% of our nations 14,550 credit unions and their 62 million members.

I appreciate the opportunity to present our views on the very limited credit union provisions which are contained in the bills, H.R. 1505 and H.R. 2094. These bills are primarily designed to recapitalize the Bank Insurance Fund and to make financial reforms to ensure a safe and sound banking system in order to avoid further burdens on taxpayers because of serious problems in the financial system. I hope our appearance here today serves to reassure you with respect to the credit union system.

The credit union movement has taken several steps in recent years to modernize and reform our financial system. We worked to achieve an independent agency and federal deposit insurance in 1970, modernized powers for credit unions in 1977, a three member Board and a Central Liquidity Facility in 1978, share drafts in 1980, and an innovative deposit-based "pay as you go" system for fully capitalizing the National Credit Union Share Insurance Fund in 1984. Most recently, credit union members have been very actively involved in a nationwide campaign to keep a separate and independent credit union regulatory and insurance system.

Because of these changes and because of the inherently less risky nature of credit union operations, the overall financial conditions of our system is quite good; and this in spite of credit unions across the country being subjected to the same economic shocks affecting other financial institutions. As an appendix to this statement, I have included a somewhat detailed summary of the overall conditions of credit unions and of the National Credit Union Share Insurance Fund. Some of the highlights as of year end 1990 are as follows:

- Credit union net income was just under 1% of average assets (95 basis points). Banks, by comparison, have been at about 50 basis points for the past two years.
- Credit union capital was increased to 7.6%.
- Loan delinquencies in credit unions actually went down during 1990 to 1.68%. This is in stark contract to banks where the ratio has been steadily climbing.
- Share Insurance Fund equity is 1.25% and has been between 1.23% and 1.28% since the Fund was capitalized by credit unions in 1985.
- The Share Insurance Fund has $2.2 billion while BIF has about $5 billion. Yet, the BIF must protect 10 times the amount of deposits in credit unions.

Further, the Treasury Department itself, in its massive study released this year Modernizing the Financial System: Recommendations for Safer, More Competitive Banks, reports on page 64 that "... credit union regulation and insurance show none of the same signs of problems as thrift regulation... " and on page 63 that "... there is no evidence that credit union regulation and insurance have been susceptible to the same kind of regulatory lapses as thrift regulation and insurance...."

In addition, a major study commissioned by the American Bankers Association which the ABA released on November 10, 1989 concluded that "... given the improving and relatively good health of the credit union industry and the NCUSIF's ability to draw upon the credit union industry for additional funding, it appears the NCUSIF is on a sound financial footing."

Mr. Chairman, my point in reviewing the overall health of our system and the recent changes made to this system is to contend that the taxpayer is best served by leaving the credit union system the way it is. Credit unions are not seeking new powers and there are no expanded business activities for credit unions in H.R. 1505.

H.R. 1505

There are two areas of concern to credit unions in the Treasury bill H.R. 1505. Most of its provision make changes to banks. The credit union movement has traditionally refrained from commenting on matters pertaining to other types of institutions. If Congress were to determine that banks should have interstate branching, or that banks should have expanded powers, or that commercial firms should own financial services holding companies, then we would accept these determinations as being in the best interests of the health of the overall financial services industry. Under any of these circumstances, we feel confident that credit unions can continue to flourish and serve their members. Our main concerns have never focused on the limitations or expansion of powers of other types of financial institutions, but rather in preserving for our citizens a separate credit union alternative to the banking system.

Section 109 provides for an expensing of our 1% deposit in the Share Insurance Fund, an expensing of each year's credit union growth adjustment to the Share Insurance Fund, and authority for NCUA to adjust the normal operating level of the Share Insurance Fund. There are two main concerns expressed by the Treasury Department to justify these changes. First, Treasury contends that a problem exists when one adds the equity in the Share Insurance Fund to the capital of the credit union movement in order to ascertain the amount of protection which exists between credit unions and the taxpayers; i.e. that the combining of these two pools of funds overstates total credit union movement capital. Second, Treasury is concerned that in a year of high losses, it would be difficult for credit unions to fulfill the requirements of their "pay as you go" system, whereby credit unions must come up with the money each year to replenish losses in the Share Insurance Fund. Because of this, Treasury feels that credit unions should be able to spread the payments over time through a premium-like system used by the FDIC.

Let me address these Treasury Department concerns. In the first instance, we concur that it is indeed incorrect to merely add the equity in the Share Insurance Fund to the capital in the credit union movement to determine the total amount of taxpayer protection. The problem here is not that there is an inadequate level of protection for the taxpayers, but rather that some observers may erroneously conclude that there are more dollars than actually exist. If this be the case, then it hardly warrants the major modifications to our system which the 1% write-down and a movement away from the "pay as you go" principle would entail. Rather, a simple method of footnoting credit union balance sheets with respect to the amount of the deposit in the Share Insurance Fund should clarify the situation.

On the other hand, if it is alleged that the amount of protection, or buffer, between credit unions and the taxpayers is inadequate, then it seems to us that the first step should be a determination of what the appropriate level of protection ought to be. I, for one, am inclined to believe that the nature of credit union operations is inherently less risky than that of the banking industry. On that basis alone, it might well turn out that our present capital level of 7.6% by itself far exceeds the taxpayer protections in a fully capitalized banking system even if the FDIC is returned to a 1.25% level. My point is that no one has ever really studied the relative riskiness of banking operations versus credit union operations. Rather, a determination is often made that "something similar to a bank standard" should be appropriate for credit unions.

With respect to the second concern raised by the Treasury Department that credit unions might find it difficult to replenish their fund during a year of high losses and that a deferred payment mechanism in the "pay as you go" system should be installed to permit a gradual repayment over a number of years, let me make the following observations: we just finished a discussion of the importance of maintaining a proper level of taxpayer protection within the credit union movement. Now it is being suggested that when losses to the Share Insurance Fund are such that its ratio is seriously reduced, thereby reducing the protection to the taxpayer, we should change the "pay as you go" method to one of paying over a period of years. This means the Share Insurance Fund ratio would stay low for this period of years. Hasn't this approach caused us problems in other federal deposit insurance funds? The idea of delaying the payment for today's problems on the assumption that conditions will be better in the future and make it easier to pay has not always produced the best results.

In addition to requiring that federally insured credit unions deposit an amount equal to 1% of their insured shares into the Fund, the federal law gives NCUA the authority to:

- Assess an insurance premium equal to 1/12 of 1% of insured shares per year;
- Require credit unions to write down part or all of the 1% deposit if large insurance losses occur; and
- Require credit unions to replenish any used portion of the 1% deposit.

This mechanism explains why credit unions themselves stand ahead of the federal government in funding insurance losses. Should the Fund ever be depleted, it will be credit unions that restore it, not the federal government. Taken to its logical extreme in an ultimate catastrophe, all additional credit union capital -- $13.5 billion -- would be transferred to the NCUSIF before the federal government would be liable for anything. When combined with the over $2 billion already in the Fund, this provides almost $16 billion before the federal government's resources are called upon. This is an amount three to five times greater than the present level of the FDIC, and the FDIC must cover 10 times the amount of deposits as the NCUSIF. The credit union movement advocated this cooperative insurance arrangement in 1984 and we stand behind it today.

We strongly recommend against changing any aspect of the current deposit-based NCUSIF insurance system.

Section 352 of the Treasury plan suggests changing the present NCUA Board structure to provide that one of three Board members be the new "Director of the Office of Depository Institutions Supervision," an official of the Treasury Department.

We feel that such a change could produce a serious imbalance away from the independent agency status which has been deemed appropriate for NCUA. The current system has worked extremely well in preserving a credit union regulatory and insurance system which is aware of and sensitive to the differences between a non-profit cooperative financial institution and the for-profit banking system.

The Treasury Department has put forward two principal arguments for including an official on the NCUA Board. First, it is suggested by Treasury that since the "full faith and credit if the United States Government" stands behind NCUSIF, the Administration should have a representative on the NCUA Board. In response to this assertion it is critical to point out that in fact Congress and not Treasury has placed our nation's "full faith and credit" behind NCUSIF, and the members of the NCUA Board remain accountable to Congress regardless of the specific individuals who compose this body. Second, Treasury believes greater uniformity and consistency could be realized in the area of financial institution regulation if this official were seated on the NCUA Board. However, it is important to note that the Federal Financial Institution Examination Council established by Congress in 1978 - P.L. 95-630 (of which the NCUA Chairman is currently a member along with the heads of the Fed, FDIC, OCC and OTS) already exists to accomplish that goal.

Mr. Chairman, we earnestly believe that once the integrity of NCUA is breached and part of its independence and authority is ceded to the Treasury Department this trend will invariable move in only one direction -- greater political control and less agency independence. Adding a Treasury official to the NCUA Board is unneeded and unnecessarily politicizes what is now an independent and a well functioning regulatory agency.

We also note that this Treasury amendment removes the prohibition that no more than two members of the NCUA Board may be of the same political party. This would, in our opinion, lead to politicizing the independent board status. The prohibition has worked well in the past and does not need changing at this time.

Tax Rules

The Committee has indicated its intentions to review the continued feasibility of current tax rules applicable to banks and other competing financial institutions in light of the proposed expanded business activities in H.R. 1505.

As I stated earlier, credit unions receive no expanded business activities under the provisions of H.R. 1505 and no changes are proposed in the tax exempt status of credit unions. I would concur that this status should remain unchanged. It was granted to credit unions on the basis that they are: not for profit; member owned and run; cooperative in nature; directed by unpaid volunteers; serving their chartered members; democratically operated under state or federal regulations; and different from banks in their underlying motives and basic approach to serving members. I firmly believe that credit unions are continuing to earn the status they presently have.

I will be happy to answer any questions the Committee might have.

Appendices

I Condition of credit union system

II AICPA letter of February 26, 1991, to Under Secretary Robert R. Glauber

III "Credit Unions' Records Show No Repair Needed" Oregonian, May 1, 1991.

APPENDIX I
Overall condition of credit unions and the Share Insurance Fund

I. CONDITION OF THE CREDIT UNION MOVEMENT

The credit union movement in the United States has never had better overall health. The aggregate level of capital in credit unions is strong, member savings are backed by a well-capitalized and well-structured federal insurance fund.

What makes credit unions so different and why haven't they experienced the same problems that have plagued banks and savings and loan associations? Basically, there are two reasons. First, credit unions by their structure are really not subject to the temptations of "moral hazard." Credit unions are non-profit financial cooperatives, owned by their depositors, and run by volunteer boards of directors. The second reason for credit unions' health at the start of the 1990s is due to their insurance system, which gives every federally insured credit union a stake in seeing that federal regulations are effective and supervisory problems are handled quickly.

A. Overview of Data

Basic facts comparing credit unions and banks, help set the stage on why the credit union system does not need major reforming. Unless otherwise noted, our comparisons are based on 1990 year-end figures.

Comparison of Basic Financial Data
June 1990

	Credit Unions	Banks
# of federally insured institutions	13,091	12,503
# under $10 million in assets	9,916	688
# over $100 million in assets	376	3,002
# over $1 billion in assets	5	372
Total assets	$195 billion	$3,360 billion
Total equity capital $$*	$14 billion	$216 billion
Equity capital as a % of assets*	7.37 (12/89)	6.23 (12/89)
Equity capital as a % of assets*	7.32 (06/90)	6.43 (06/90)
Loan loss allowance as % of assets	0.52%	1.49%
Net charge-offs as % of total loans (Half Year, Annualized)	0.62%	1.44%
Long-term delinquency as % of loans**	0.71%	3.18%
% of U.S. consumer savings***	4.4% (12/80)	41.9% (12/80)
% of U.S. consumer saving***	6.4% (6/90)	48.6% (6/90)

* Excludes allowances for loan losses. All credit union capital must be raised through retained earnings. For banks, however, of the 6.43% only 2.9% is from retained earnings and the other 3.6% is from stock issues.

** Loans 6 months delinquent or longer

*** Total consumer savings equal household deposits in credit unions, banks, S&Ls, mutual savings banks, non-institutional money market mutual funds, and U.S. savings bonds.

To highlight a few of these figures, note:

- Banks hold 10 times the amount of deposits of credit unions, but BIF has only about two times the capital of NCUSIF. BIF stands near $5 billion, NCUSIF has $2.2 billion. While all of these bank assets are not insured, this is significant if banks can be "too big to fail" and BIF has to pick up the pieces.

- Most credit unions are small and therefore spread NCUSIF's risk of loss. The 423 banks over $1 billion in assets hold about 70% of all bank assets.
- Banks anticipate 3 times the amount of loan losses than do credit unions.
- Credit unions are flattered by those that allege they are taking over the world, but the facts show that ten years ago credit unions held a little over 4% of consumer savings, and today they hold 6%. Banks' increase in market share in the last 10 years from 42% to 49% equals credit unions' entire share of the market.
- The capital position of credit unions is stronger than that of banks, and every dollar of credit union capital is pure capital built up through retained earnings.

B. The Current Financial Condition of Credit Unions

The year 1990 was not a particularly good one for financial institutions. The economy was buffeted by its first recession since 1982. The S&L industry continued to atrophy. Although the banking industry as a whole is relatively healthy, bank profits were eroded by provisions for loan losses, particularly in the hard-hit commercial real estate market.

When considering the combined data of all federally insured credit unions, one is struck by absence of any real evidence of the recession. Credit union net income (the source of additions to capital) was just under 1% of average assets, at 95 basis points. That marked the fifth year in a row that net income was between 90 bp and 100 bp of average assets. At commercial banks, net income the past two years has been just under 50 basis points, down from around 80 basis points in 1988.

As a result of strong earnings and moderate growth, the overall credit union capital-to-asset ratio (excluding loss allowances) rose again to 7.55% as of December 1990, from 7.35% the previous year. Similarly computed bank capital stood at 6.46% of assets at the end of 1990.

Most surprising is the absence of the emergence of asset quality problems in credit unions last year. The proportion of loan balances in accounts in which payments were at least 2 months past due (the delinquency rate) actually fell in 1990, from 1.77% at the end of 1989 to 1.68% at the end of 1990. At commercial banks, the ratio of nonperforming loans to gross loans (similar to credit union delinquency, but excluding delinquency of less than 90 days) rose from 2.99% in 1989 to 3.68% in 1990.

Credit union loan losses have also changed very little in the past few years. Provisions for loan losses were 40 basis points of average assets in 1988, 45 basis points in 1989, and 48 basis points in 1990. Over the same period, bank loan loss provisions have risen from 56 basis points in 1988 to 97 basis points in 1989 and 95 basis points in 1990.

About the only way the recession shows up in national credit union statistics is in the changing growth rates of member loan demand and savings supply. In times of recession, consumers tend to save more and borrow less against the possibility that their incomes might be interrupted. At credit unions, savings growth accelerated from 5% in 1989 to 8% in 1990. At the same time, loan growth slowed from 8% in 1989 to 3% in 1990.

Some effects of the recession do appear in credit union data for some states in New England. Net income is down, and loan delinquency and charge-offs are up. But, accounting for loan losses by actual net charge-offs, no state's credit unions had negative net income in 1990. Accounting for loan losses by provisions for current and future loan losses, only one state (Massachusetts) lost money in 1990.

On the whole, credit unions have come through the recession thus far in remarkably good condition. This fact, plus the experience of Texas credit unions in oil depression of the mid-1980s attest to the fact that credit unions, with their predominantly consumer loan portfolios, are, if not insulated, at least much less sensitive to business cycles than are other financial institutions with more commercial exposure.

II. CONDITION OF THE NATIONAL CREDIT UNION SHARE INSURANCE FUND

A. Overview of the Relative Health of the Federal Insurance Funds

In the last ten years, the U.S. deposit insurance system has developed severe problems. FSLIC has gone bankrupt, and FDIC, also healthy in the 1970s, has recently experienced difficulties.

In contrast, the National Credit Union Share Insurance Fund (NCUSIF) has remained safe and stable during the same period. Federally insured credit unions took a bold step in the mid-1980s to design an insurance program that requires them to maintain a 1% deposit in the National Credit Union Share Insurance Fund (and to make an annual adjustment to the 1% based on savings growth). Credit unions have never received the recognition they deserve in taking this unprecedented action. Real dollars -- $800 million -- were mailed to the U.S. Treasury in January 1985. So long as credit unions remain sound, these deposited funds remain listed as an asset of the credit union. If problems develop, the NCUSIF will spend the money to deal with them, credit unions will have to expense the amount of the deposit used by the NCUSIF, and credit unions will have to -- as required by federal statute -- mail more, real dollars to the government to maintain their 1% deposit and the stability of their insurance fund. By federal law, no taxpayer money can be used to bail out any credit union until the $2.2 billion currently in the NCUSIF and the remaining $13.5 billion of credit union capital is used in the event of a financial catastrophe.

The credit union federal insurance fund has shown in the last five years that it works, deserves recognition, and should remain independent from the problems that plague banks and savings and loans. The NCUSIF now has reserves equal to 1.25% of insured deposits, and it has maintained that level while other federal deposit insurance funds have suffered severe losses. The experience at the credit union fund, at a time when the other two systems have malfunctioned, suggests that something about credit unions and their share insurance system works.

We believe there are two chief reasons the NCUSIF has held up so well. First, credit unions are largely immune from the "moral hazard" problem that plagues the other funds. Second, the unique method by which NCUSIF is capitalized sets in place healthy, risk-reducing incentives. We turn now to explanations of these two features.

B. The Key to How the Structure of the NCUSIF Minimizes the Liability of the Federal Government -- A Deposit-Based System With a Replenishment Requirement

The NCUSIF is not funded in the same way as the other federal deposit insurance systems. Instead, federally insured credit unions are required to maintain a deposit at NCUSIF equal to 1% of each credit union's insured savings.

The NCUSIF retains the income earned on this deposit. At an 8% return, NCUSIF's annual earnings on the funds deposited with it are roughly the equivalent of a 1/12 of 1% annual premium.

Once a year, federally insured credit unions forward to NCUSIF an amount equal to 1% of their insured savings growth during the preceding year to "top off" their 1% deposits. This automatically adjusts the 1% deposit portion of the Fund to keep up with insured savings growth at credit unions. Earnings from the Fund's investments are used to pay insurance losses and other NCUSIF administrative expenses. The balance of earnings are retained by NCUSIF to maintain the total capital of the Fund near 1.25% of insured savings. Should the Fund ever climb above 1.3%, the surplus over 1.3% must be returned to credit unions as a dividend on their 1% deposits.

In addition to requiring that federally insured credit unions deposit an amount equal to 1% of their insured shares into the Fund, the federal law gives NCUA the authority to:

- Assess an insurance premium equal to 1/12 of 1% of insured shares per year;
- Require credit unions to write down part or all of the 1% deposit if large insurance losses occur; and
- Require credit unions to replenish any portion of the 1% deposit written down.

This mechanism explains why credit unions themselves stand ahead of the federal government in funding insurance losses. Should the Fund ever be depleted, it will be credit unions that restore it, not the federal government. Taken to its logical extreme in an ultimate catastrophe, all additional credit union capital -- $13 1/2 billion -- would be transferred to the NCUSIF before the federal government would be liable for anything. When combined with the over $2 billion already in the Fund, this provides almost $16 billion before the federal government's resources are called upon. This is an amount far greater than the present level of the FDIC, and the FDIC must cover 10 times the amount of deposits as the NCUSIF. The credit union movement advocated this cooperative insurance arrangement in 1984 and we stand behind it today.

The NCUSIF is deliberately structured to replenish losses as they occur in order to avoid the situation where problems are allowed to build up over the years. Credit unions were vitally interested in preventing the sort of situation which eventually brought down the FSLIC. Every month NCUA staff makes a public report on the status of the Fund's payouts and investments, and annually an independent audit is conducted of the Fund by Price Waterhouse, providing additional public overview on the operations of the Fund.

The replenishment feature of the 1% deposit does more than put all credit union capital ahead of any taxpayer liability. It also changes incentives that affect how credit unions view their regulator. This means that credit unions have an incentive to offer less resistance to, and more support for, regulatory policies and supervisory attention which reduce risk to the insurance fund. This produces a system in which credit unions, in effect, mutually reinsure one another. It creates what we might refer to as "moral fortitude," as contrasted with moral hazard. Each credit union has an incentive to support their regulator in efforts to curb the behavior of any other credit union taking excessive risk.

C. Condition of the NCUSIF Today

As of September 30, 1990 (the end of NCUSIF's fiscal year), the equity ratio of the Fund was 1.25, the same as at the end of the previous year. The ratio has stood between 1.23% and 1.28% since the fund was capitalized by credit unions in 1985. The maintenance of the 1.25% ratio in 1990 was achieved despite an almost $30 billion buildup of reserves to cover future insurance losses.

The NCUSIF has for several years reserved for future losses as they become probable in a manner similar to that suggested for BIF by Comptroller General Charles A. Bowsher.

The reason for such favorable results is likely attributable to two factors: (1) credit union operations are inherently less risky; and (2) the NCUSIF system recognizes and deals with losses as they occur. Individual losses to an insurance fund usually occur in manageable proportions. Problems arise when several large losses occur at the same time (very unlikely except in a catastrophe) or when several large losses spread through time are not recognized as they occur and must all be dealt with at the same time. The FSLIC catastrophe illustrates the second case.

With the current NCUSIF deposit system, annual funding to cover operating expenses and insurance losses comes from two sources. The first is the NCUA's earnings on the Fund's equity -- the balance is currently $2.2 billion. The second is NCUA's ability to levy a 1/12 of 1% annual premium. This premium has been waived since credit unions capitalized the fund in 1985 because most of the money collected would merely have been rebated at the end of each year.

APPENDIX II

AICPA

American Institute of Certified Public Accountants

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February 26, 1991

Mr. Robert R. Glauber
Under-Secretary for Finance
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Mr. Glauber:

RE: Credit Union Accounting Proposals in Treasury's February 1991 Report - Modernizing the Financial System (the "Treasury Report")

The American Institute of Certified Public Accountants (AICPA) Credit Unions Committee (Committee) has reviewed the proposal in the subject report and offers the following comments for your consideration. Specifically, the Committee has focused on Part One-VIII which contains recommendations to change the way credit unions account for payments into the National Credit Union Share Insurance Fund (NCUSIF). Those payments are made to meet the insurance requirement that a credit union maintain on deposit with NCUSIF (the "deposit") an amount equal to one percent of the credit union's total insured shares and savings accounts (the "insured savings").

The Treasury Report recommends that the NCUSIF deposit be expensed by credit unions; a twelve-year transition period is suggested. We understand the Administration's legislative proposal will incorporate such a provision. We are concerned about the accounting and auditing ramifications of such a legislative mandate.

We draw your attention to letters we wrote to Congresswoman Marcy Kaptur dated April 3, 1989 and to the Department of the Treasury dated May 4, 1990 (attached). Those letters set forth our position that the deposit is properly accounted for as an asset by credit unions. Indeed, the Treasury Report acknowledges that "the accounting method [by credit unions] is consistent with generally accepted accounting principles (GAAP) and is supported by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants."

The NCUSIF deposit is accounted for as an asset in the financial statements of credit unions because it represents a probable future economic benefit to the credit union. This deposit allows the credit union to have its shares federally insured and is refundable to the credit union upon withdrawal from the system or liquidation. This benefit derives from the underlying capitalization of NCUSIF which currently exceeds one percent of total credit union deposits. In the event of a "crisis" that causes the NCUSIF reserve funds to be inadequate to provide for the risk of loss, the asset would be impaired because it would no longer be recoverable in cash from the NCUSIF and would no longer represent any future economic benefit to the credit union. GAAP would then require an estimated loss to be accrued in the period in which it becomes probable that the asset is impaired and the amount can be reasonably estimated.

The Treasury Report does not recommend any change to the facts and circumstances underlying the deposit mechanism; the rights and privileges of credit unions with respect to the deposit would remain the same. If our understanding is correct and the asset has not been impaired, we do not understand why it should be expensed over a twelve-year period. If the asset has been impaired, then that should be clearly stated, and the asset should be written off in the year it has been impaired. We foresee the following problems if the recommendation is enacted:

1. It will create a difference between GAAP and regulatory accounting principles (RAP) that may be inconsistent with the intent of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to reduce GAAP/RAP differences.

2. It may result in credit unions receiving qualified audits from their auditors.

3. It will result in immediate income statement recognition of required increases or decreases in the NCUSIF deposit, causing earnings fluctuations.

These matters are discussed further in the following paragraphs. In addition, we offer alternative approaches for your consideration.

GAAP vs. RAP Difference

If implemented, NCUA will require credit unions to expense the deposit for regulatory reporting purposes. Thus, a GAAP/RAP difference in accounting for the deposit will be created. Such differences are inconsistent with the current effort of the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve Board to narrow GAAP/RAP differences as prescribed by FIRREA. Such differences confuse the public and undermine the credibility of financial reporting.

Auditor's Opinion

If a credit union does not deviate from NCUA prescribed accounting for the deposit in its externally published financial statements, a credit union's assets and equity will be understated under GAAP, and the credit union's auditor may qualify his or her opinion. Such a qualification sends a negative signal--which would not be justified--to readers of the credit union's financial statements as to the financial condition of the credit union.

Income Fluctuation

Implementation of such a requirement will affect the credit union's income based on subsequent increases or decreases in the deposit. The Treasury proposal could have a significant impact on the reported income of a credit union in that future payments to NCUSIF would be required to be treated as expense (and refunds treated as income). Thus, a credit union that receives a significant increase in deposits during a year, even if received on the last day of the year, would be required to expense one percent of the increase in that year. Conversely, a significant decrease in deposits would give rise to income.

Alternative Approaches

The Treasury Report states that the counting of insurance fund assets as credit union assets should be eliminated and that this would create an additional layer of protection for the taxpayer. It is our understanding that this "protection" is accomplished by more conservatively stating credit union capital. We offer the following two alternative approaches for your consideration:

1. We recommend that credit unions prepare their financial statements in conformity with GAAP. If regulators wish to determine the adequacy of a credit union's capital, such a calculation can be made--outside the financial statements--using GAAP equity as a starting point.

2. Credit unions are currently required by the Federal Credit Union Act to annually transfer a certain percentage of gross income to a statutory reserve. This reserve is not available for dividend distribution. We understand that NCUA could change the methodology for calculating statutory reserves for credit unions so as to ultimately include an extra one percent for all insured shares. This would be reflected by credit unions as an allocation of undivided earnings that would not be available for member distribution.

* * *

Thank you for this opportunity to address our concerns on this matter. Representatives of the AICPA are available to meet with you or your staff at your convenience to discuss this matter further.

With sincere regards,

Joe Moraglio

Joseph F. Moraglio, CPA
Vice President
Federal Government Division

Attachments

APPENDIX III

Credit unions' records show no repair needed

By RICHARD L. GARLOCK

IN MY OPINION

The congressional proposal to force solvent, well-managed credit unions into the same pool as banks and savings and loans is a bad idea.

The bill introduced by Rep. Henry Gonzalez, D-Texas, the chairman of the House Banking Committee, would make the Federal Deposit Insurance Corp. responsible for all such federal insurance funds and would transfer regulatory responsibility for credit unions to a new federal agency.

In a January 1991, "Dear Colleague" letter, Gonzalez wrote that "strong federal oversight and regulation is imperative to ensure the safety and soundness of not only the industry but the federal insurance funds."

To inject a few facts:

- Nationally, credit-union delinquency rates on loans are at least one-third less than the delinquency rates at banks. Oregon credit unions have a loan delinquency rate of at least two-thirds less than the delinquency rates at banks.
- The fraud rate at banks, according to 1989 federal bank examiners statistics, is more than 30 times higher than it is at credit unions, and the loss from fraud at banks is more than double the loss at credit unions.
- Credit unions are closely regulated by state or federal agencies, with more than 60 percent of credit unions under federal charter. Many federal regulations also affect state-chartered credit unions.

Arguments in favor of the bill ignore the axiom: "If it ain't broke, don't fix it."

Credit unions are not "broke." Many of us believe this bill is one step toward grabbing the strong, sound National Credit Union Insurance Fund to help offset savings and loans fund losses. The credit union fund is the healthiest of all of the federal insurers. The fund, to which all Oregon credit unions belong, has $1.25 in reserve for every $100 in insured deposits; the FDIC has less than 60 cents per $100.

However, the National Credit Union Insurance Fund is a relatively small fund of $2.1 billion — not even big enough to offset the $2.6 billion in losses from the failure of Lincoln Savings & Loan alone.

Why are credit unions so successful? Their focus is on people, not profits. Most of them are very small, organized around a common interest — employer, union, trade association or similar cohesive group. Only members borrow money or make deposits, and they elect their own volunteer boards of directors to make policy and approve loans.

Responsible consumerism is encouraged: counseling is often offered members with financial problems. Most loans are for such items as college tuition, automobiles and vacations. A few large credit unions now make loans for homes or other major items.

Credit unions usually charge lower interest on loans and pay higher dividends on savings than do banks. This is possible because (1) boards of directors are made up of unpaid volunteers, (2) credit unions are non-profit and do not have to pay money to stockholders, and (3) credit unions are not permitted to lend money for highly leveraged corporate buyouts or for other speculative enterprises, or to foreign countries. Members pay their own taxes on their interest earnings.

I know of no one familiar with the credit union's family-oriented service role who is in favor of dumping these small, locally controlled, solvent, regulated credit unions into the same administrative and regulatory bucket with mammoth, profit-oriented banks and savings and loans. Each type of institution meets specific public needs and objectives. In the event a merger is forced, it doesn't take much of a prognosticator to guess which objectives would prevail.

The failure of the Rhode Island State Insurance Fund (which was not part of the National Credit Union Insurance Fund) is no excuse for the harsh methods incorporated into proposed legislation, which would, in effect, penalize thousands of credit unions for being prudent and responsible financial entities.

Gonzalez's bill is akin to cutting off an arm to get rid of a hangnail. Credit unions "ain't broke." They have earned the right to continue to provide small loans and safe havens for cash for 62 million Americans, including the 835,000 Oregonians, who are fortunate enough to be credit-union members. I hope that every member writes his congressional representative to oppose the bill.

OREGONIAN 5-1-91

Richard L. Garlock is executive director of the Portland-based Oregon Association of Independent Accountants and president of the National Society of Public Accountants.

Mr. GIBBONS. All statements will go in the record.

Mr. Horowitz.

STATEMENT OF GEDALE B. HOROWITZ, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION (SENIOR EXECUTIVE DIRECTOR, SALOMON BROS. INC., NEW YORK, N.Y.)

Mr. HOROWITZ. Mr. Chairman, my name is Dale Horowitz. I am senior executive director of Salomon Bros. I am serving currently as chairman of the Securities Industry Association, in which capacity I appear today.

I want to thank you, Mr. Chairman, and the committee for the opportunity to present SIA's views on financial restructuring in general and the tax and debt management of the Treasury's legislative proposal, H.R. 1505, in particular.

Before turning to the theme of our current tax laws which favor commercial banking organizations with expanded business activities over the securities industry, I think it would be helpful if I were to set out SIA's perspective in general on the current debate on financial restructuring.

Almost 2 years ago before the Treasury had even begun to study the issue, SIA announced it would support comprehensive change in the laws governing financial institutions. We announced that we were willing to have banks as competitors in the securities business if, and only if, commercial banks in the securities business operate without Federal subsidies and in a way that enhances the safety and soundness of the Federal Deposit Insurance System, thereby protecting taxpayers as well.

Since our Nation cannot afford another massive bailout of failed financial institutions, we must ensure that allowing expanded powers for commercial banking organizations does not expand the safety net in any way. We believe, along with the Treasury, that this is the time for financial restructuring.

We do have a branching system that is in need of assistance. Title II of the Treasury proposals expands the Federal safety net and competitively disadvantages the securities industry in two critical areas.

Title II would leave risky securities and securities-like activities inside insured banks. Second, title II would permit the "new financial services holding company" to cross-market and tie services and products offered by federally insured banks with new securities services and products similar to your insurance and deposit example this morning, Mr. Chairman. As a result, title II of the Treasury bill would both disadvantage securities firms and, more important, increase taxpayer risk. These competitive disadvantages for the securities industry in title II of H.R. 1505 are compounded by the tax advances over securities firms now enjoyed by commercial banking organizations.

This combination of Federal deposit insurance, the "too-big-to-fail" doctrine, and significant tax preferences for banks is the Federal equivalent of shortening the fences for one team every time it is at bat in a baseball game. Mr. Chairman, we are firmly committed to keeping the fences the same for both teams and keeping the American taxpayer and the securities industry in the game.

I turn now to the tax preferences that favor conducting business in an insured bank. These preferences cost the taxpayers money and H.R. 1505 would expand them. The American taxpayers pay twice for these preferences: First, from induced tax revenues; and second, from increased pressures on subsidized deposit insurance. Moreover, these tax preferences are for banks unfairly discriminated and disadvantage securities firms that are not affiliated with commercial banks because these securities firms must compete with federally subsidized bank competitors. In SIA's views, banks enjoy substantial tax advantages over their competitors, including securities firms, in four principal areas: Funding of operations, investment management, multinational operations, and proprietary trading in debt securities.

First, commercial banking organizations enjoy significant funding advantages in attracting capital from foreign lenders. In general, foreign investors will not lend funds to U.S. borrowers unless the interest income earned by those investors is exempt from U.S. withholding tax.

Tax exemption from interest on deposits and restrictions on the portfolio interest exemption for other U.S. borrowers means banks have greater access than securities firms and other taxpayers to the international capital markets for both short- and long-term funds.

Unlike other taxpayers, a U.S. bank can also fund its domestic operations with loans from its own foreign affiliate without incurring any negative U.S. tax consequences.

Second, banks traditionally have enjoyed tax advantages over securities firms in the management of passthrough investment funds. Funds sponsored by securities firms typically must qualify under the complex and technical regulated investment company rules of the Tax Code, which limit both the kinds of income the funds can earn and the kinds of assets in which they can invest. Bank-sponsored investment funds can serve the same purpose as, for example, mutual funds sponsored by the securities industry, but bank-sponsored funds are not subject to any Tax Code limitation on the kind of assets they may hold or on the kind of income they may earn. H.R. 1505 recognizes that the law of governing bank-sponsored common trust funds in particular is uncertain in its scope. As a result, such funds have the potential to be used in certain cases as largely unregulated competitors with mutual funds.

Accordingly, H.R. 1505 would modify the securities law regulation of common trust funds to correct this potential abuse except for a special rule dealing with tax-free rollovers in mutual funds.

H.R. 1505 is silent, however, on the special tax status enjoyed by collective investment and common trust funds.

SIA believes this situation could be rectified if H.R. 1505 amended the Tax Code to provide that a bank-sponsored fund will be exempt from complying with the Tax Code's regulated investment company rules only if that fund is not registered under the 1940 Act.

Third, when American banks and securities firms compete in foreign markets, the U.S. Tax Code should not favor one at the expense of the other. At present, however, the Tax Code, in fact, contains two important rules that favor multinational U.S. banks, even though the underlying logic of these rules applies with equal vigor to multinational securities firms.

First, interest allocation rules for foreign tax credit purposes permit a U.S. affiliated group to treat a bank affiliate, but not a securities affiliate, as a separate subgroup. As a result, U.S. interest expense of a bank subgroup does not taint the ability of nonbank affiliates to utilize their own foreign tax credits.

Second, the passive foreign investment company rules of the Tax Code, in effect, treat bank and securities activities by a foreign subsidiary of a U.S. bank as an active business, but treat similar activities by a foreign subsidiary of a securities firm as passive and, therefore, subject to punitive tax rules. There is simply no policy justification for these dramatic differences in the taxation of multinational operations of U.S. financial institutions.

Finally, banks have tax advantages in trading for their own account in debt securities because gains or losses on such trading is always ordinary. For securities firms, by contrast, the character of gain or loss depends on the context. It is ordinary only if the security is held for sale to customers. Since corporations always find that characterization of gain or loss as ordinary rather than capital is preferable, the present tax regime is a subsidy to banks conducting proprietary trading operations.

I thank you, Mr. Chairman. I am prepared to answer any questions.

[The prepared statement follows:]

STATEMENT OF GEDALE B. HOROWITZ
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

Introduction

I thank the Chairman and the Committee for the opportunity to present SIA's views on financial restructuring in general and the tax and debt management aspects of Treasury's legislative proposal (H.R. 1505) in particular.

H.R. 1505 in its current form contains only a handful of very modest amendments to the Tax Code, and I will offer limited testimony on those proposals today. SIA does, however, believe that the Committee has identified an important -- and to date undeveloped -- issue in the ongoing debate on financial restructuring by its request for testimony "regarding the continued feasibility of current tax rules applicable to banks and other competing financial institutions in light of the proposed expanded business activities that would be permitted pursuant to [H.R. 1505]." I intend to address this theme in the bulk of my testimony. At the outset, however, I think that it would be helpful if I were to set out SIA's perspective in general on the current debate on financial restructuring.

The Need For Financial Restructuring

The financial marketplace is in desperate need of restructuring. The problems of the commercial banking industry are daily reminders that significant change is necessary, and SIA strongly supports financial restructuring so that our financial markets retain their international preeminence in the rapidly changing financial environment.

In fact, almost two years ago, SIA announced it would support comprehensive change in the laws governing financial institutions, including changes in the Glass-Steagall Act. At that time, SIA said that Congress, not banking regulators, is the appropriate body to undertake comprehensive change.

SIA's position is that securities firms would be willing to have commercial banks as competitors in the securities business if -- but only if -- commercial banks operate without federal subsidies and in a way that enhances the safety and soundness of the federal deposit insurance system, thereby protecting taxpayers as well. As the members of this Committee well know, our nation cannot afford another massive "bail-out" of failed financial institutions. Moreover, the revenues for any such "bail-out" would have to be raised by this Committee and the Congress. Therefore, we must ensure that allowing expanded powers for commercial banking organizations does not expand the federal safety net in any way.

By dropping its traditional opposition to banks entering the securities business, SIA believes it has come a great distance in searching for common ground in the nation's best interests. We have developed a proposal which we believe will reduce the risks to the deposit insurance system while allowing banking organizations to engage in new activities on an equal footing with their competitors. We are frankly disappointed that other groups have not come forward to search for a solution that is fair, safe and sound. SIA still hopes others will join the effort.

While SIA commends the Treasury Department for pursuing a comprehensive approach to dealing with the problems of the commercial banking industry, SIA is distressed that particular sections of H.R. 1505 expand the power of commercial banks at the expense of the securities and other industries -- a win/lose situation. Financial restructuring should not be a "zero sum game."

Title II of the Treasury bill makes federally insured banks the centerpiece for expanded powers for commercial banking organizations -- that is, bank holding companies and their federally insured subsidiary banks and their noninsured, nonbank subsidiaries. SIA has two principal concerns with the approach proposed by Treasury in Title II. First, Title II would leave risky activities, such as foreign exchange trading, inside insured banks.[1]

Second, Title II would permit the new "financial services holding companies" to cross-market and tie services and products offered by federally-insured banks with new securities services and products. Tying -- the ability of a commercial bank to use its credit relations and power to forcefully or subtly "suggest" the purchase of other services such as securities or insurance -- cannot be allowed. Unfortunately, in the name of "synergy," the Treasury bill would allow complete credit, cross-marketing, and managerial personnel support by federally insured banks of their securities and insurance affiliates. Synergy, in this context, often means "tying." This commingling of business between the insured bank and the securities affiliate increases the likelihood of the entire holding company being "too big to fail," thereby again increasing, rather than reducing, the risks of another "taxpayer bail-out." Anti-tying provisions therefore should be included in the legislation both to prevent unfair competition as well as to reduce the risk to taxpayers.

As a result of these two factors -- the inclusion of risky businesses inside an insured bank and the utilization of "tied" banking and securities services and products -- Title II of the Treasury bill would both disadvantage securities firms and, more important, increase taxpayer risk. Loading more risk onto the federal deposit insurance system and onto taxpayers would not be good public policy.[2]

The Principles for Financial Restructuring

We believe the basic principles for financial restructuring should be these:

1. Risk to the taxpayers, who ultimately stand behind the federal deposit insurance safety net, should be reduced, not increased. This is done by shrinking the scope of the activities which the net covers inside federally insured banks and ensuring that the net does not extend to affiliates of federally insured banks. For example, a federally insured bank (often "too big

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[1] SIA is also concerned that Title II of the bill lacks strong credit and personnel firewalls and customer information protections. These concerns were addressed, however, by the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs.

[2] Entry into the securities business will not necessarily reduce the riskiness of the banking business. For example, after the October 1987 crash, 40 percent of securities firms reported losing money each quarter from 1988-1990.

to fail") should not be conducting, itself or through an affiliate it is supporting, foreign exchange, swaps and other counterparty transactions or, at a minimum, any "wholesale" securities and securities-related activities that the private sector has demonstrated can be carried on successfully without government support and taxpayer risk. Federally insured deposits should not be financing, for example, foreign exchange trading. Instead, financial services holding companies should be required to conduct these risky activities in non-insured and separately capitalized subsidiaries (without guarantees or credit supports from the insured bank).

2. There should be competition without federal subsidies in the securities, securities-related and other businesses in which commercial banking organizations are to be authorized to participate. After all, if banks are now to be allowed to compete with securities firms that are their customers, those customers should not be disadvantaged by the government support that federally insured banks enjoy. Such businesses should be conducted in separate entities which do not have any access to the credit and power of their affiliated federally insured banks. Moreover, such businesses should not be the beneficiaries of "tying" arrangements with their federally insured bank affiliates. To allow otherwise would promote unfair competition and unnecessary risk for the taxpayer.

3. Market forces, rather than regulators, should determine success or failure in securities and securities-related activities. By conducting more of its activities (including all "wholesale" securities and securities-related activities) outside of its federally insured banks, a commercial banking organization should become more regulated by the market, less reliant on federal support and less in need of regulatory control and oversight. Market-driven commercial banking organizations will be healthier, more competitive, have more straightforward accounting and be better able to adjust to changing times.

4. There should be freedom of choice. The securities industry is remarkably diverse, with its members ranging from the very large international diversified financial services firms to small regional brokerages. This diversity has brought creativity to the American financial marketplace, to the benefit of consumers and corporations alike. Congress should not design a financial system which requires securities firms to affiliate with federally insured commercial banks so they can continue to be competitive in the businesses in which they are already successful. Owning a federally insured commercial bank should not be a competitive advantage in the securities business.

Financial Restructuring and the Tax Law

As this brief summary suggests, much of SIA's prior testimony on H.R. 1505 focused on controlling the subsidy extended to commercial banks through the deposit insurance system and the "too big to fail" doctrine.[3] In that testimony, I emphasized that commercial banking organizations should be permitted to participate in securities and securities-related businesses if -- but only if -- the banks operate their securities businesses without federal subsidiaries and do not add risk to the federal deposit insurance system -- and, therefore, to the taxpayer. Requiring banks to establish separately capitalized securities affiliates with anti-tying provisions and strict firewalls between bank activities and securities activities, as we have recommended, would achieve both of these objectives.

Today, in discussing the tax laws that govern banks and their competitors, I turn to subsidies of a different nature.[4] We believe that businesses that compete with each other should be taxed similarly; similar transactions conducted by different entities should be taxed similarly; and differences in the cost of capital between competitors should be the result of market forces, not the Tax Code or other government intervention. Current Tax Code preferences granted to federally insured banks, however, violate these principles.

Whenever the tax system accords preferential treatment to securities-related activities conducted within the four corners of a bank charter, business organizations will have an incentive to bring those activities inside a bank, rather than to conduct those activities through an unsubsidized securities firm. This incentive costs the taxpayer money, in the form of the reduced tax revenues that follow from increased use of a tax preference. The incentive also puts more pressure on the size of the subsidy provided to banks in the form of deposit insurance -- pressure which will only grow if H.R. 1505 expands the scope of securities-related businesses in which commercial banking organizations are permitted to engage. Finally, tax preferences that favor conducting business inside an insured bank unfairly disadvantage securities firms that are not affiliated with commercial banks, because they must compete with federally-subsidized bank competitors.

SIA recognizes that the Tax Code's subsidies to commercial banks several years ago were far more extensive than they are today. Prior to the Tax Reform Act of 1986, in particular, banks were the beneficiaries of several large tax subsidies.[5] As a result of the work of this Committee, the most important of these tax subsidies have been eliminated, although favorable transition rules have provided substantial post-1986 benefits to commercial banks.[6]

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[3] SIA testified before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs on April 18, 1991, and before the Senate Committee on Banking, Housing, and Urban Affairs on May 16, 1991.

[4] My testimony is limited to comparing the taxation of U.S. securities businesses and U.S. banks. U.S. branches of foreign banks may have other tax advantages over U.S. securities firms.

[5] For example, unlike securities firms and other taxpayers, banks were entitled to deduct each year additions to bad debt reserves. These additions often bore no resemblance to their actual loan loss experience. (The bad debt reserve rules are still preserved for banks having assets of $500 million or less.)

Nonetheless, the Tax Code still contains a number of rules that encourage financial activities undertaken by federally-insured banks at the expense of the same financial activities conducted by other financial institutions. In SIA's view, banks enjoy substantial tax advantages over their competitors, including securities firms, in four principal areas: funding of operations, investment management, multinational operations, and proprietary trading in debt securities.[7]

Bank Tax Advantages in International Funding Operations

Commercial banks enjoy significant funding advantages in attracting capital from foreign lenders. Banks can access a greater number of international markets with fewer tax formalities.

In general, foreign investors will not lend funds to U.S. borrowers unless the interest income earned by those investors is exempt from U.S. withholding tax. A special exemption from U.S. withholding tax applies to interest paid on bank deposits. By contrast, U.S. securities firms (and other U.S. borrowers) must rely either on the Tax Code's withholding tax exemption for short-term (183 day or less) discount obligations or, in the case of longer-term debt, the Code's withholding tax exemption for "portfolio interest" paid to certain foreign lenders.

The "portfolio interest" withholding tax exemption, the only one available for long-term debt of securities firms, does not apply to loans from foreign banks. Thus, a U.S. bank can fund its domestic operations with certificates of deposit issued to foreign banks, while a U.S. securities firm in general cannot go to the same foreign bank lenders to obtain term loans with maturities of greater than 183 days.[8] Moreover, in the case of short-term funding, U.S. banks can issue EuroCDs in maturities that are not available to the paper of other U.S. issuers.[9]

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[6] For example, commercial banks generally were permitted to "recapture" their bad debt reserves over four years, and financially troubled banks can suspend indefinitely their recapture obligations.

[7] This list is not intended, of course, to be an exhaustive presentation of all points of difference in the taxation of banks and securities firms, but rather an overview of those differences that are particularly relevant to the issue of financial restructuring.

[8] It is true, of course, that tax treaties sometimes reduce withholding tax on interest paid to treaty residents to zero. In this regard, however, it is important to keep in mind that, in the absence of a domestic withholding tax exemption, the United States imposes withholding tax on interest paid to residents of Japan, Switzerland and Canada -- three important sources of foreign bank financing.

[9] Most bearer-form Eurocommercial paper programs for U.S. issuers have been cut back to 183 days because purchasers of short-term Euromarket instruments are unwilling to accept

(continued...)

Another set of tax rules permits a U.S. bank to fund its domestic operations with loans from its own foreign affiliates without incurring any negative U.S. tax consequences, whether in the form of withholding tax or in the form of an increased tax burden on the bank borrower itself. U.S. securities firms (and other U.S. borrowers), by contrast, cannot rely on the "portfolio interest" exemption for interest paid to foreign affiliates, and borrowings by a U.S. securities firm (or other U.S. borrower) from a foreign subsidiary generally are subject to punitive levels of tax under the "subpart F" rules of the Tax Code.[10]

The tax law should not skew access to international capital in favor of banks at the expense of securities firms and other financial services entities. At a pragmatic minimum, therefore, SIA suggests that the existing tax loopholes encouraging U.S. banks to fund their domestic operations with deposits from foreign affiliates be plugged. Ideally, more comprehensive tax reform in this area would enable securities firms (and other financial services businesses) to have the same access to foreign bank lenders as U.S. banks currently enjoy.

Bank Tax Advantages in Investment Management

Banks traditionally have enjoyed tax advantages over securities firms in the management of investment funds. By sponsoring investment or mutual funds, the securities industry gives small investors access to professional expertise and economies of scale that would otherwise be reserved for large and sophisticated investors. This activity is especially important given recent trends in the securities industry. In recent years, fees from asset management and commissions from mutual fund sales remained two of the industry's revenue sources with steady growth. For example, asset management fees grew from $200 million in 1980 to $2.2 billion last year.

In order to be taxed as pass-through entities (so that investors do not bear a double level of tax), these funds typically must qualify under the rules of the Tax Code defining

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[9](...continued) certification of non-U.S. beneficial ownership. The portfolio interest exemption requires such certification; the deposit interest exemption does not. This discrepancy creates a window of opportunity for banks in the period from six months (when the certification requirement kicks in for Eurocommercial paper) to one year (when all bearer notes, including EuroCDs, must comply with the certification requirement).

[10] More specifically, a loan from a controlled foreign corporation (a "CFC") to a U.S. shareholder generally is treated as an "investment in U.S. property" under Code § 956, which in turn triggers tax to the U.S. shareholder under § 951(a)(1)(B). Deposits in U.S. banks are exempt from this rule (§ 956(b)(2)(A)). Similarly, "portfolio interest" earned by a CFC from an unrelated U.S. borrower is always taxed to the U.S. shareholder of the CFC as "subpart F" income; bank deposit interest earned by the same CFC is not subpart F income to the CFC's U.S. shareholder if the interest is subject to tax in the CFC's jurisdiction at rates comparable to U.S. rates. (§ 954(b)(4); § 881(c)(4).)

regulated investment companies ("RICs"), real estate investment trusts ("REITs") and real estate mortgage investment conduits ("REMICs"). The tax rules under which RICs, REITs and REMICs operate are complex and technical; those rules limit both the kinds of income that funds can earn and the kinds of assets in which they can invest.

Under sections 501 and 584 of the Tax Code, banks also manage pooled investment funds that are treated as pass-through entities for tax purposes. Although these "collective investment trust funds" and "common trust funds" can serve exactly the same purpose (at least for certain investors) as, for example, RICs sponsored by the securities industry, collective investment and common trust funds are not subject to any limitations on the kind of assets they may hold (including diversification requirements) or on the kind of income they may earn.[11] To take just one example, a RIC will lose its tax-qualified status if it earns 30 percent or more of its income from the sale of securities held for less than three months; collective and common trust funds are not subject to these limits.[12]

H.R. 1505 recognizes that the securities law governing common trust funds in particular is uncertain in its scope, and as a result common trust funds have the potential to be used in certain cases as competitors with RICs. Accordingly, H.R. 1505 would bring common trust funds that are advertised or offered to the public within the scope of the Investment Company Act of 1940.

H.R. 1505 is silent, however, on the special tax status enjoyed by collective investment and common trust funds.[13] SIA believes that the intent of the drafters of H.R. 1505 was to provide that a fund that registers under the '40 Act (as a result of H.R. 1505 or otherwise) must also qualify as a RIC (or other pass-through entity) for tax purposes. The tax definitions of collective investment and common trust funds, however, are wholly independent of the terms' definitions for securities law purposes. As a result, there is some confusion as to the scope of the special Tax Code rules for common trust funds following the enactment of H.R. 1505, and publicly-offered collective investment trust funds arguably are wholly unaffected by H.R. 1505. SIA believes that this situation could be rectified if H.R. 1505 amended the Tax Code to provide that sections 501 and 584 of the Tax Code will apply to a collective investment or common trust fund only if that fund is not a registered investment company under the '40 Act.

Bank Tax Advantages in Multinational Operations

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[11] "Collective investment trust funds" are vehicles for the pooling of pension plan and IRA investors. These funds are treated as tax-exempt entities under Code § 501 by virtue of Revenue Ruling 81-100, 1981-1 C.B. 326.

[12] We observe that insurance companies have similar advantages over classic securities firms through pooled segregated asset accounts under Code § 817.

[13] The only amendment made by H.R. 1505 to the Tax Code with respect to common trust funds is to provide for tax-free transfers from common trust funds to RICs.

One of the avowed purposes of H.R. 1505 is to enable large diversified American financial institutions to compete in the global marketplace. We support the Treasury Department's efforts to improve the global competitiveness of American financial institutions, both through the financial restructuring that Congress is considering, and through negotiations in the Uruguay Round of the GATT.

When American banks and securities firms compete in foreign markets, the U.S. Tax Code should not favor one at the expense of the other. To countenance a competitive environment skewed by tax favoritism would violate all the principles that I articulated earlier that should govern the financial restructuring process. It would encourage taxpayers to place securities-related activities inside the four corners of a bank, rather than in a non-federally insured securities firm (thereby increasing the cost of the tax preference and the extent of the deposit insurance system's coverage), and it would subsidize one group of U.S. firms at the expense of other direct U.S. competitors. Yet at present the Tax Code in fact contains two important rules that favor multinational U.S. banks -- even though the underlying logic of these rules applies with equal vigor to multinational securities firms.

A U.S. affiliated group of corporations is required to allocate its domestic interest expense between its U.S. and foreign source income to determine for U.S. tax purposes the effective foreign tax rate imposed on its foreign earnings, and thereby the amount of foreign tax credits available to offset U.S. tax on the group's worldwide income. Because these interest expense allocation rules reduce a U.S. group's usable foreign tax credits, but not the foreign taxes actually paid, these allocation rules expose U.S. companies doing business abroad to substantial risks of double taxation on their foreign income. This problem of "excess" foreign tax credits -- the polite term for effective double taxation of foreign income -- is endemic to most U.S. multinationals, but is compounded in the case of highly leveraged institutions, such as banks and securities firms.

In 1986, Congress recognized that a strict application of this one-group interest allocation rule was inappropriate for financial institutions. The regulated activities and capital structure of financial institutions, and the special relationship between their liabilities and assets, effectively preclude the use of funds borrowed by a financial institution to support income-producing activities of other affiliates. At the same time, financial institutions traditionally have much higher leverage than industrial firms.

For these reasons, the Tax Code allows a U.S. affiliated group to treat bank affiliates as a separate "sub-group" for interest allocation purposes. As a result, interest expense of a bank "sub-group" does not taint the ability of non-bank affiliates to utilize their own foreign tax credits.

The Tax Code does not, however, permit a U.S. affiliated group of corporations to treat members that are securities broker-dealers as a separate "sub-group." As a result, even though broker-dealer firms are subject to regulation in the use of their capital in a manner analogous to bank regulation, and even though broker-dealers also are highly leveraged as a matter of course, domestic interest expense incurred by a U.S. broker-dealer can limit a non-broker dealer affiliate's ability to utilize its own foreign tax credits.[14]

Under the current tax regime, diversified holding companies and financial services holding companies will have a strong incentive to move a securities-related business that requires significant borrowings and that can be conducted by a bank (e.g., a foreign currency trading operation) into a bank subsidiary, thereby confining the group's foreign tax credit problems in the bank "sub-group." The result will be to increase the direct tax cost to taxpayers of bank operations and the indirect cost to taxpayers of increasing bank risk. The result also will be to put U.S.-based multinational groups that contain a broker-dealer affiliate at a competitive disadvantage to otherwise similarly-leveraged groups with a bank affiliate, because in the latter case, the effects of interest allocation will be safely "bottled up" in the bank sub-group.

SIA has no quarrel with the application of the special "sub-group" rule to isolate non-bank members of an affiliated group from the toxic foreign tax credit effects of the interest expense allocation rules as applied to bank affiliates. At the same time, however, the logic of this rule applies with equal vigor to broker-dealer firms. In SIA's view, it is a major failing of H.R. 1505 that it extends the securities powers of commercial banking organizations, without at the same time recognizing that, in light of the policy underlying the foreign tax credit rules, the Tax Code should extend to multinational securities firms the same interest allocation rules that apply to multinational banking groups.

In another area that is important to multinational securities firms, the "passive foreign investment company" ("PFIC") rules of the Tax Code in effect treat bank and securities activities by a foreign subsidiary of a U.S. bank as an "active" business, but treat similar activities by a foreign subsidiary of a securities firm as "passive," and therefore subject to punitive tax rules.[15] There is simply no policy justification for this dramatic difference in the taxation of multinational operations of U.S. financial institutions, and I urge that the PFIC rules be amended to recognize that foreign subsidiaries of U.S. securities firms are just as "active" as foreign subsidiaries of U.S. banks.

Bank Tax Advantages in Proprietary Trading

Banks have tax advantages in trading for their own account in debt securities. Under a special rule in the Tax Code, banks can treat gain or loss on debt instruments as ordinary income or loss.[16] For securities firms, by contrast, the character of gain or loss depends on the context - it is ordinary only if the security is held for sale to customers.

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[14] Additional technical rules compound this foreign tax credit problem when a U.S. corporation does business abroad through subsidiaries rather than through branches. For historical and regulatory reasons, securities firms conduct their foreign business through subsidiaries, while banks generally use branches.

[15] Code § 1296(b)(2)(A); Notice 89-81, 1989-2 C.B. 399.

[16] Code § 582(c).

Under today's tax rate structure, corporations always find that characterization of gain or loss as ordinary, rather than capital, is preferable. Tax rates for corporations on ordinary income and capital gains are currently the same, but ordinary loss is fully deductible, while there are limits on the deductibility of capital loss. The difference between ordinary and capital treatment has become even more important in recent years since the Supreme Court's decision in Arkansas Best.[17]

Banks can ignore this concern. Securities firms, by contrast, can incur capital losses on non-customer trading.[18] I am not sure that the present tax regime was intended as a subsidy to banks conducting proprietary trading operations, but that is what this provision has become. SIA urges that the trading activities of banks be subject to the same rules as to character of gain or loss as apply to any other taxpayer.

Conclusion

The nation has an opportunity now to effect financial restructuring in a way that decreases taxpayer risk and promotes competition. The securities industry supports change that is fair, healthy for the financial markets as well as the securities and banking industries, and an improvement for the taxpayer.

Thank you very much for the opportunity to testify today. SIA would be pleased to provide any additional information that the Committee may request or to answer any questions that the Committee may have.

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[17] Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

[18] This different treatment of identical activities is compounded by the technical rules of Code § 1236, under which securities firms can inadvertently incur ordinary income and capital loss.

Mr. GIBBONS. Thank you.

Mr. KINGMAN. Mr. Chairman, I was not aware Mr. Hughes was going to exceed his time limit in attempting to rebut my statements here. I wonder if you would be kind enough to grant me a couple of minutes.

Mr. GIBBONS. Go right ahead.

Mr. KINGMAN. Thank you.

First of all, Mr. Hughes, you mentioned you would not permit me to join your credit union. As an honorably discharged Navy veteran, would you still make that claim?

Mr. HUGHES. No.

Mr. KINGMAN. Would you care to retract that statement?

Mr. HUGHES. Not exactly. I meant as a private citizen, not in the field of membership if you fit that category, that you would not be able to join.

Mr. KINGMAN. I am an honorably discharged Navy veteran. Could I join your credit union?

Mr. HUGHES. No.

Mr. KINGMAN. I tested this over the phone and they indicated it was sufficient to become a member. Maybe you better talk to some of your service representatives.

Mr. Chairman, the credit union history in every single testimony I have been involved with always compares credit unions to the large commercial banks such as CitiCorps, Bank of Boston, Bank of New England, what-not in terms of payment to directors, size of loans and this type of thing. I have yet to hear them compare themselves to the community banks and particularly the mutual banks such as mine because the organizational structure is so similar that one is hard pressed to find many differences.

For example, we exist for the protection of depositors. We have no stockholders. Any funds left over in the bank after dividends and expenses and taxes are retained in the bank for the benefit of depositors. We are cooperative in nature.

We do make small loans down to $500.

Trustees get paid a total of $400 a year for being trustees of a bank. As I have said many times, if any trustee was a trustee in order to get $400, I wouldn't want him as a trustee.

I think you will find that for the community banks there is a great deal of similarity in product line, in structure, and the whole thing.

I have made the statement that politically, if our elected leaders cannot bring themselves to create the level playing field by taxing the credit unions above $25 million on the same basis we are taxed, perhaps the best way to do it is to grant the 6,000 or 7,000 mutual cooperative banks, savings banks, or savings and loans associations the same tax subsidies. In other words, tax-free operation so that we all compete in the same playing field on that basis.

I think that possibility could be inserted into the bill to give the option and let the free marketplace decide as to where we want to go that we could change our charter to a Federal credit union and operate on the same basis as they do.

He mentioned the expensing of the insurance premiums. Yet, another credit union in my area, a $250 million Federal credit union, lists $4.3 million in capital of which $2.7 million is the insurance premium, leaving it at 0.6 percent capital as a Federal credit union.

Mr. Hughes commented their risk was much lower. That particular credit union has $41 million in commercial loans on its books.

Another Federal credit union in my area pays interest on commercial checking accounts. It is the only bank charter in America permitted to do that.

When I suggest that the product line sometimes exceeds the product line of the community banks, it is those types of things that I am talking about, sir.

Thank you for the extra time. I appreciate it.

Mr. GIBBONS. Ms. Lauder, why do your constituents want to get in the insurance business and in the real estate business?

Ms. LAUDER. I think our constituency wants to get into these other businesses to be able to level the playing field. As was pointed out in my testimony, our competitors are far beyond what we think of in terms of the normal commercial bank operation, but without bank regulation.

We are competing with Prudential, we are competing with the securities firms. Yet banks shoulder a lot more restrictions with capital requirements, CRA requirements and the like.

We are interested in it for the level playing field competitiveness.

Mr. GIBBONS. What real estate firms are you competing with?

Ms. LAUDER. Well, I think to the extent many of these financial services firms that I have cited in my testimony have real estate operations, we are certainly competing with them.

Mr. GIBBONS. I suppose you would be just as happy if we regulated them a little more and perhaps left you in the field you have traditionally been in?

Ms. LAUDER. I don't believe the bill authorizes any new real estate powers for banks.

Mr. GIBBONS. It authorizes subsidiaries; doesn't it? What happened to that?

Ms. LAUDER. I don't believe it is in there.

Mr. GIBBONS. That relieves one of my problems.

You are right, Mr. Horowitz. We do need to look at all the tax laws and how they affect the different institutions. I don't remember us having done that in a long time around here. Conditions have changed. As far as credit unions are concerned, I don't see any reason why you should not be taxed. If you make a profit and your competitor doesn't make a profit, I can't see any reason why you should not be taxed.

Mr. HUGHES. It is not a profit as such in that we have been trying to build up our reserves so that we are a solid institution and not dependent on falling back on the taxpayer eventually, as many other of our financial institutions have had to do.

We were about 4 percent in reserve at Navy Federal Credit Union about 1983, 1982, in that timeframe. We saw that we had to get more of a foundation there in order to be stable in a very interest risky environment. As such, we have been trying to build our reserves up to be stable within that, and within the guidelines of the NCUA we stand climbing really. We have further to go. It is not a profit per se. It is trying to build our reserves as such. It still belongs to the member owners of our institution.

Mr. **Kingman**. Mr. Chairman, my net profit after taxes also goes in my capital account, just exactly like a credit union does. I have 8¼ percent capital. We have maintained a high capital ratio sufficiently in excess of what is required by the FDIC because of the various real estate developments in New England. So far, we have yet to have a losing month. We are continuing to build that. The problem is that we can only grow as fast as we grow capital.

When we have to pay a 48-percent tax rate, that is $48 out of every $100 we earn that we cannot put in a capital account that the credit union does. That way they can grow at a much, much faster rate.

That is why the credit union industry is the fastest growing financial service industry in the country because of that phenomenon.

Mr. **Gibbons**. They appear to be that way in my area, too. I just look at the size of the buildings they are moving into.

Mr. **Kingman**. Looking at three of them I gave to the committee, I call it the American tax dollar at work.

Mr. **Gibbons**. Ms. Lauder, do you think that $30 billion direct Treasury borrowing being considered by the House Banking Committee is the appropriate means to recapitalize the Bank Insurance Fund?

Ms. **Lauder**. Well, as you know, the industry is committed to paying for the moneys needed in the Bank Insurance Fund. Whether $30 billion is the correct number, we rely on the information given to us by the FDIC.

I believe under their current analysis, even in a sort of a pessimistic scenario, they show a $5 billion shortfall. Based on the current estimates given by the Government, we believe that would be appropriate.

Mr. **Gibbons**. What I am wondering about, I guess, is the difference between borrowing from the Federal Reserve and borrowing directly from the Treasury. Which do you all prefer?

Ms. **Lauder**. We prefer what is the most efficient cost of funds. We are committed as an industry to making the repayment.

Mr. **Gibbons**. Have you all formed any opinion about which is the most efficient way to borrow?

Ms. **Lauder**. I don't have the information here with me to respond to that question. We can certainly respond to that in writing.

Mr. **Gibbons**. That would be helpful. I wish you would send a copy of it to my office. By the time I get it over there from here, it is ancient history.

[The information follows:]

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

DIRECTOR, TAX AND ACCOUNTING
Henry Ruempler
202/663-5317

June 14, 1991

The Honorable Dan Rostenkowski
Chairman, Committee on Ways & Means
U.S. House of Representatives
Longworth House Office Building
Washington, D.C. 25015

Dear Mr. Chairman:

In response to questions and issues raised at the May 29, 1991 hearing of the Committee on Ways & Means on the Administration's banking reform proposal, the American Bankers Association (ABA) is pleased to provide this additional information for inclusion in the public record.

First, Rep. Sam Gibbons asked whether the ABA had a position on FDIC borrowing from the Treasury Department or from the Federal Reserve as part of the BIF recapitalization plan in H.R. 1505. The decision of whether the Bank Insurance Fund should borrow from the Treasury or from the Federal Reserve to meet liquidity needs may be based on considerations that go beyond the concerns of the banking industry. From the banking industry perspective, it is important that the method will provide sufficient funds to ensure that BIF can close insolvent institutions, but will not unnecessarily constrain credit availability by removing more money from the banking system than is needed. Either source should be able to provide that "as needed" liquidity. Because the banking industry will be repaying the amounts borrowed through a special assessment, this suggests using the lowest cost source of funds. It is expected that the costs of borrowing from the Treasury or the Federal Reserve will be comparable to the extent that the FDIC notes will be backed by the full faith and credit of the U.S. Government. There remains a question whether the use of an intermediary such as the Federal Reserve will result in a slight risk premium. Certainly, there is precedent for the FDIC turning to either Treasury or the Federal Reserve, the FDIC has long had borrowing authority from the Treasury and originally the Federal Reserve held stock in the FDIC.

Second, an exchange between Rep. Gibbons and the Securities Industry Association (SIA) witness highlighted the need for additional information with respect to the relative tax treatment of commercial banks and securities firms. It was alleged that banks enjoy a tax advantage in four areas: funding of operations, investment management, multi-national operations and proprietary trading in debt securities. There are provisions in these areas which treat commercial banks differently than securities firms, but in some cases the provisions do not provide a benefit, and in other cases a comparison between banks' and securities firms' activities do not justify comparable tax treatment.

International Funding Operations

First, commercial banks do not have a funding advantage either from differences in the application of the portfolio interest exemption from the 30% withholding tax or from the existence of the deposit exemption from the same tax. The portfolio interest exemption, adopted in 1984 (with the support of the ABA, SIA and U.S. Treasury--See hearing of Committee on Ways & Means May 1, 1984), applies equally to all U.S. borrowers. Thus, a commercial bank or a securities firm can issue a Eurodollar obligation in bearer form under the IRC Section 163 rules and the holder of the obligation can receive interest free of the 30% withholding tax. Foreign banks may be holders of the debt obligations, just like any other passive investor. Foreign banks, however, are not eligible for the portfolio interest exemption for payments they receive on loans made in the ordinary course of business, whether that loan is made to a commercial bank, a securities firm or any other U.S. borrower. That provision was put in at the request of the Federal Reserve in order to prevent foreign banks especially those located in tax haven jurisdictions, from exploiting U.S. loan markets. Moreover, most foreign bank loans to U.S. securities firms are made by U.S. branches of the bank (because they are dollar denominated transactions) and as such as not subject to the withholding tax at all.

No comparison of the portfolio interest exemption and the deposit exemption is appropriate. The deposit exemption from a 30% withholding rule was put in the Code in 1921 (though by means of a source rule rather than an exemption) for the purpose of permitting U.S. financial institutions to compete for funds in the international marketplace. The deposit exemption has been and continues to be justified separately from the portfolio exemption. Moreover, the SIA seems to argue that the purchase of long term debt of securities firms is some how a comparable function to the foreign purchase of a U.S. bank certificate of deposit. A deposit in a U.S. bank is not a capital contribution, but a liability on the books of the bank and involves enormous costs such as FDIC insurance premiums and Federal Reserve reserve requirements, which the deposit exemption is designed to offset. In contrast, a long term debt obligation of a securities firm is added to the capital of the firm and does not involve the enormous costs comparable to those applied to U.S. bank deposits.

A second funding issue raised relates to the rules under IRC Section 956 covering investments by controlled foreign corporations (CFCs) in U.S. property. CFCs which are not subject to immediate repatriation rules under Subpart F (e.g. those in high tax jurisdictions or earning non-Subpart F income) may nonetheless lose their deferral of U.S. tax where they purchased the debt of its U.S. parent. See Rev. Rul. 89-73. In contrast, the SIA argues that the exemption for CFC deposits in U.S. banks provides a funding advantage for commercial banks. It should be observed, however, that the exemption for bank deposits in Section 956(b)(2)(A) is available to all CFCs, not just those controlled by U.S. banks.

The bank deposit exemption results in lower borrowing costs for U.S. bank customers, such as consumers and businesses, just as the exemption for investments in U.S. obligations does for the U.S. government. If the purchase of obligations of securities firms by CFCs will result in a comparable economic benefit for the customers of the securities firms, then perhaps Congress should consider whether to revise the law. If, however, the only result is a capital infusion to the securities firms, it cannot be argued that is comparable to the benefits accorded to borrowers by means of the bank deposit exemption.

Moreover, interest earned on a U.S. bank deposit by a CFC is U.S. source income to the CFC, but subject to local country tax in the jurisdiction where the CFC is located. While the CFC incurs local country tax, there is no associated foreign tax credit on the income paid to or imputed to the U.S. parent because that CFC deposit income is a U.S. source. This double tax should not be compounded by altering the Section 956 exemption for bank deposits.

Investor Management

Banks through their common trust funds and collective investment funds do not enjoy tax "advantages" over securities firms management of their investment funds because bank funds are established for unique and different purposes and must adhere to rules tailored to the purposes of those funds.

Common trust funds are required to meet certain standards as to the type of assets they may hold, contrary to SIA's assertion. Each state promulgates fiduciary guidelines which all trustees including banks which establish common trust funds are required to meet. These rules are, in general based on the "prudent man rule" which governs the investment of trust assets. A duty to diversify investments is an integral part of the "prudent man rule".

In addition, the Office of the Comptroller of the Currency (OCC) has issued regulations that common trust funds must meet. In order to retain its tax exempt status the common trust fund must abide by the OCC rules. The rules in 12 C.F.R. 9.18(b)(9) provide that a bank common trust fund may not invest more than 10% of the fund in securities of a single issuer and further, that no single trust may own more than 10% of the common trust fund.

The limitations on the assets common trust funds may hold are, of course, different from those governing mutual funds because of the different nature of common trust funds. Collective investment funds which include pension or profit-sharing trust assets, in addition to meeting the OCC requirements, must comply with all the rules and regulations of ERISA.

H.R. 1505 provides that common trust funds which are advertised or offered to the public would come within the scope of the Investment Company Act of 1940. The ABA envisions that if a registered common trust fund is marketed and advertised to the public then that entity would be subject to the tax treatment of regulated investment companies found in IRC Sections 851-855. However, because of positions taken by the SEC, certain funds even though they are not marketed to the public must be registered under the Investment Company Act of 1940.

For example, if an individual names a bank as trustee of his IRA rollover, the SEC takes the position that the trust may not be invested in the bank's common trust fund unless that fund is registered. Similarly, the SEC has declined to rule that a common trust fund in which a bank invests trusts created under a common form trust agreement, comes within the exemption from registration. The SEC so holds even though such trusts are valid under state law.

A bank faced with the need to manage efficiently the assets of many different trusts may decide to register its common trust fund in order to comply with the SEC's position. Again, these funds are not marketed to the public nor do they behave as a mutual fund. If it were not for the position of the SEC they would not be registered. These funds should retain the tax treatment provided to them under IRC section 584.

The Treasury bill permits a true level playing field. Securities firms through holding companies may own banks and trust companies and operate common and collective trust funds, provided they conform to all the requirements of these funds.

Indeed, some securities firms already own banks or trust companies.

Multinational Operations

Commercial banks can put their banking companies in a sub-group for interest expense allocation under IRC Section 861, but that is not a tax benefit. Frankly, the ABA has not found any consistent opinion among its member banks concerning the sub-group rule for bank holding companies. Banks have very different experiences under the rule depending on how they are funded e.g. by deposits held by the bank or by commercial paper issued by the holding company. Similarly, the source of income from non-bank subsidiaries affects the impact of the rule on the taxpayer groups.

There is also concern that the PFIC rules treat bank and securities related income as "active" in the hands of banks but passive in the hands of securities firms. (See IRS Notice 89-81). Such income is treated as active income in the hands of commercial banks only if its a "true" commercial bank not a sham set up in a tax haven jurisdiction. If a securities firm can make the case showing a valid purpose for other than the passive income treatment, the IRS could issue a notice to clarify the application of the rules. IRS Section 1296(b)(2)(A) specifically provides the Treasury with authority to limit the application of the rules in the case of corporations other than commercial banks. Therefore, this issue can be addressed by administrative action, legislation is not needed.

Proprietary Trading of Debt Obligations

Since 1969 commercial banks have been subject to ordinary gain or loss treatment on sale or exchange of all debt obligations under IRC Section 582(c). During the 17 years leading up to the Tax Reform Act of 1986 this provision was not seen as a benefit to the commercial banks, because most taxpayers wanted the opportunity to have a lower tax rate on capital gains. (In 1969 the rate disparity was 48% to 28%). It is only with the repeal of the preferential rate for capital gains that other taxpayers are now concerned.

The rationale behind Section 582(c) is that debt obligations are like inventory in the hands of commercial banks. This logic is sound as banks tend to increase their holdings of debt obligations when loan demand goes soft and reduce holdings of debt when loan demand is increasing. Given the intermediary function that commercial banks perform in the U.S. economy, the ordinary gain or loss treatment is valid. Dealers in debt and equity securities are given ordinary treatment under IRC Section 1236 because those activities by securities firms are more in the nature of inventory--a parallel to the Section 582(c) provision for commercial banks.

The SIA has identified a problem, however, specifically that the repeal of the corporate capital gain rate, without a parallel repeal of a capital loss limitation rule creates an inequity for all corporations. Banks suffer that same inequity in certain areas, including the sale or exchange in shares of bond mutual funds and even worse in the case of routine asset and liability hedging. In the case of hedging IRS agents are taking the position that gains are ordinary and losses are capital so that the taxpayer cannot even net the hedging gains or losses before facing the IRS whipsaw. Indeed, if there is an advantage, it is that securities firms largely have elective treatment ordinary or capital, depending on their own accounting classification. This allows the securities firm to get capital gain for transactions in debt securities to offset capital losses elsewhere, a benefit banks do not have. This is crucial in light of Arkansas Best uncertainties.

The banking industry has lived with the ordinary gain or loss rule for 22 years and it is prepared to stick with that treatment even if Congress enacts a general capital gains rate for corporations in the future. It is unclear whether other taxpayers would be willing to live with ordinary treatment on such obligations in a corporate capital gains environment.

* * *

ABA appreciates the opportunity to provide this additional information to the Committee in connection with the testimony presented on May 29, 1991. If the Committee staff has any questions or needs additional information, they should feel free to call me at (202) 663-5317.

Sincerely,

Henry Ruempler

Henry Ruempler

Mr. **Gibbons**. Ms. Lauder, would you explain how the proposal to identify FDIC insurance bank accounts by a taxpayer's Social Security number for the account holders would affect the banking industry?

Ms. **Lauder**. My understanding of that provision is that there will be an identification by Social Security number.

The concern of the American Bankers Association is that that not be linked with the tax rules that require Social Security number and identification numbers for backup withholding, which are currently in place and have penalties connected with them. We would like to keep that separate.

Based on the current proposal with the prospective date of 2 years, we have no problem with that.

Mr. **Gibbons**. Well, I want to thank each one of you for coming today and helping us with this problem.

With that, we will declare this session over. Thank you very much.

[Whereupon, at 2:45 p.m., the hearing was adjourned.]

[Subsequently, the following letter was received:]

NAVY
FEDERAL
CREDIT UNION
P.O. Box 3000
Merrifield, VA 22119-3000

Office of the President

June 14, 1991

Chairman Dan Rostenkowski
Committee on Ways and Means
United States House of Representatives
Washington, D. C. 20515

Dear Chairman Rostenkowski:

On behalf of the Credit Union National Association (CUNA) and the National Association of Federal Credit Unions (NAFCU), I want to thank you, Mr. Chairman, and your distinguished colleagues on the Committee, for the opportunity to testify before the panel on May 29, 1991. These important hearings focused on certain aspects of the Administration's proposal to recapitalize the Bank Insurance Fund (BIF), modify the regulation of banks and other depository institutions, and expand allowable activities of banking corporations.

While your hearing was not convened to examine the specific issue of credit union taxation, that matter did surface during the course of the hearing. I would like to take this opportunity to provide you with additional information and request that it be included in the official hearing record.

While quite rare, it is not unheard of for some credit union critics to claim that from $2 billion to $5 billion a year would be generated by taxing credit unions. Such estimates are simply erroneous. As the enclosed Table from the President's Fiscal Year 1992 Budget clearly indicates, exempting all credit unions from Federal income tax is estimated to result in outlay equivalents of $605 million in FY'90, $635 million in FY'91 and $665 million in FY'92. The actual revenue loss is projected to be $430 million in FY'90, $450 millon in FY'91 and $470 million in FY'92. In fact, both the Congressional Budget Office and the Joint Committee on Taxation estimate that taxing "credit unions over $10 million would raise approximately $3.4 billion over the next four years."

Far more costly to the United States Treasury and our nation's taxpayers is the revenue loss to Treasury from the "special merger rules for financial institutions," with their outlay equivalents of $5.6 billion in FY'90, $5.7 billion in FY'91 and $4 billion in FY'92; and, revenue loss of $3.9 billion

Continued
Page Two

in FY'90, $3.9 billion in FY'91 and $2.8 billion in FY'92. I would like to emphasize that there are no credit unions benefitting from these special rules, although significant numbers of other types of financial institutions clearly enjoy the tax benefit afforded by these special merger rules.

Mr. Chairman, given the $500 billion price tag handed over to the American taxpayer resulting from the S&L debacle and the unfortunately grave situation now faced by the BIF, it is essential that you and this distinguished panel be provided with accurate and reliable information. We strongly believe that the income, especially in comparison to our current budget deficit, which would accrue to the Treasury from taxing credit unions pales in comparison to the potential negative impact to these member-cooperatives. Once credit unions begin to look at the bottom line as a paramount concern, they will begin to move down a most uncertain path.

Mr. Chairman, NAFCU and CUNA, along with the over 13,000 credit unions they collectively represent, feel confident in our ability to defend the credit union tax exemption on the merits. We stand ready to provide you and your colleagues with factual, reliable information.

I want to thank you again, Mr. Chairman, and the Committee, for the opportunity to testify on May 29th. As the Ways and Means Committee continues its consideration of legislation to recapitalize the BIF and to reform critical elements of our banking sector, please do not hesitate to call upon CUNA and NAFCU directly for the provision of any assistance or additional information.

Sincerely,

T. J. Hughes
President

TJH/hf

Enclosure

cc: The Honorable Bill Archer
The Honorable Sam Gibbons

Table XI–1. **ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX**

(In millions of dollars)

Description	Outlay Equivalents			Revenue Loss					
	1990	1991	1992	Corporations			Individuals		
				1990	1991	1992	1990	1991	1992
National defense:									
Exclusion of benefits and allowances to armed forces personnel	2,280	2,340	2,400				1,955	2,010	2,060
International affairs:									
Exclusion of income earned abroad by United States citizens	1,590	1,655	1,670				1,205	1,255	1,305
Exclusion of income of foreign sales corporations	1,315	1,470	1,655	895	1,000	1,125			
Inventory property sales source rules exception	3,780	4,295	4,845	3,780	4,295	4,845			
Certain nonfinancial institutions operations interest allocation rules exception	130	135	145	85	90	95			
Deferral of income from controlled foreign corporations:									
Normal tax method	300	320	350	300	320	350			
Reference tax method									
Total (after interactions)	7,115	7,875	8,665						
General science, space, and technology:									
Expensing of research and development expenditures:									
Normal tax method	1,750	1,800	1,895	1,720	1,770	1,865	30	30	30
Reference tax method									
Credit for increasing research activities	1,625	1,680	1,220	1,115	1,155	835	25	25	15
Suspension of the allocation of research and experimentation expenditures	340	925	370	230	630	250			
Total (after interactions)	4,050	4,750	3,795						
Energy:									
Expensing of exploration and development costs:									
Oil and gas	–500	–280	–15	–425	–230	–5	–75	–50	–10
Other fuels	45	50	50	40	45	45	5	5	5
Excess of percentage over cost depletion:									
Oil and gas	860	895	925	110	115	120	540	560	580
Other fuels	220	235	255	135	145	155	10	10	10
Capital Gains treatment of royalties on coal		10	10					5	10
Exclusion of interest on State and local industrial development bonds for energy facilities	315	300	285	255	240	230			
Alternative, conservation and new technology credits:									
Supply incentives	110	105	35	75	70	25			
Conservation incentives	*	*	*	*	*	*			
Alternative fuel production credit	15	60	200	10	35	100	*	10	35
Alcohol fuel credit	*	80	210	*	80	210			
Special rules for mining reclamation reserves	50	50	50	45	45	45	5	5	5
Exception from passive loss limitation for working interests in oil and gas properties	245	280	310				180	205	225
Total (after interactions)	970	1,265	1,645						
Natural resources and environment:									
Expensing of exploration and development costs, nonfuel minerals	40	45	45	35	40	40	5	5	5
Excess of percentage over cost depletion, nonfuel minerals	415	460	515	300	330	365	20	20	25
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	1,715	1,615	1,510	1,425	1,330	1,240			
Tax incentives for preservation of historic structures	145	145	145	50	50	50	95	95	95
Capital gains treatment of iron ore		*	*					*	*
Capital gains treatment of certain timber income		10	15					5	10
Expensing of multiperiod timber growing costs	360	400	430	205	225	240	155	175	190
Investment credit and seven-year amortization for reforestation expenditures	215	225	235	40	40	40	170	175	185
Total (after interactions)	2,830	2,840	2,840						
Agriculture:									
Expensing of certain capital outlays	495	450	320	60	50	35	435	400	285
Expensing of certain multiperiod production costs	180	160	155	60	55	50	120	105	105
Treatment of loans forgiven solvent farmers as if insolvent	10	15	15				10	10	10
Capital gains treatment of certain income		65	100					45	70
Deferral of 1988 drought-relief payments	–125	–10					–125	–10	
Total (after interactions)	530	640	555						
Commerce and housing credit:									
Exemption of credit union income	605	635	665	430	450	470			
Excess bad debt reserves of financial institutions	155	130	145	155	130	145			
Special merger rules for financial institutions	5,635	5,720	4,005	3,885	3,945	2,760			
Exclusion of interest on life insurance savings	7,925	8,560	8,585	55	85	115	7,265	7,840	7,845
Special alternative tax on small property and casualty insurance companies	*	*	*	*	*	*			
Tax exemption of certain insurance companies	25	25	30	15	20	20			
Small life insurance company deduction	110	115	135	80	85	100			

[Submissions for the record follow:]

Statement
# of the
Association of Reserve City Bankers
to the Committee on
Ways and Means
U.S. House of Representatives

June 1, 1991

The U.S. deserves banking and financial policies suited to its role as a leader in the world today. Such policies should seek to:

- *Develop and sustain public confidence in the U.S. banking and financial system.*
- *Provide the public with the benefits of healthy competition in financial services.*
- *Create an environment in which bank capital can be generated in support of future economic activity and financial stability.*
- *Reduce institutional exposure to losses by allowing greater diversification of assets and by allowing banks to follow their customers and adjust to their changing financial needs.*
- *Lower the deposit insurance system's exposure to unnecessary potential losses in the future.*
- *Eliminate uncertainty about the intent and consistency of bank supervision and regulation, and control the hidden costs of overly burdensome and complex regulations that are imbedded in the delivery of financial services.*
- *Allow U.S. banks to regain ground they have lost and hold their own against competitors in domestic and foreign markets.*
- *Enhance business and financial planning through clearly stated goals and intentions of future banking policy while providing a clear expression of interest on behalf of the public in the need for healthy, stable and competitive banking markets.*

The Association of Reserve City Bankers (ARCB) believes such banking and financial policies are worthy of this country as a world leader and that steps should now be taken to adopt them. The recommendations put forward by the administration in the Treasury Department report Modernizing the Financial System: Recommendations for Safer, More Competitive Banks represent a major step forward in achieving this.

ARCB supports the proposals in the Treasury report which would reform the deposit insurance system, modernize the banking system and make the bank regulatory system operate more efficiently in the future. ARCB believes the type of comprehensive reform package proposed by Treasury is in the national interest. Such reforms should be phased-in to avoid disruptions to the banking and financial system. Future banking policies should also be mindful of the market requirements faced by banks domestically and internationally as they seek to remain competitively viable in the future.

The issues most critical in achieving these objectives have been thoroughly studied over the years. Congress now should act positively to implement them at an early date. Any suggestions ARCB puts forward toward those recommendations are made for the purpose of improving them and are not intended to stand in the way of the adoption of a comprehensive set of policies that would secure a more modern and efficient banking and financial system.

Deposit Insurance Reform

ARCB believes the deposit insurance system should be reformed to reduce coverage to depositors who do not need protection, remove incentives for undue risk taking and lower the deposit insurance system's exposure to unnecessary potential loss. All are unfortunate and unintended outcomes of the existing system.

Reform of the deposit insurance system could begin with a reduction in the current level of deposit insurance coverage. The proposed reduction in coverage to $100,000 per person, per institution recommended in the Treasury report is a good place to start, but further reductions could be sought in the future. Another important step would be to eliminate coverage for brokered deposits, bank investment contracts and pass-through accounts that are professionally managed. There should be no coverage for non-deposit creditors of banks or their parent companies. These steps represent an enhancement of the principle of market discipline.

ARCB believes every effort should be made to eliminate the perception that some banks are too big to fail. Nonetheless, if the government seeks to protect all depositors when it makes a determination that a bank failure poses a potentially serious systemic risk to the financial system, protections to uninsured depositors should be made only on the basis of the benefit to society at large. The extra costs of covering uninsured depositors in such instances should not be covered out of the Bank Insurance Fund (BIF). Unlike most other reform measures which should be phased-in, this step should be implemented now. ARCB supports the "final settlement payment" proposal put forward by the ABA to cover uninsured depositors in bank failures. ARCB is recommending a self-regulatory system for the industry to use in the marketing of non-insured products designed to protect the public against potential abuse in this area.

Determinations about the least-cost method of resolving an individual bank failure, without regard to its systemwide impact, could remain a decision of the FDIC's, without regard to any risk other than that faced by an individual institution. Such decisions should, however, take into account the implication which they would have in perpetuating the principle of too-big-to-fail, and they should also take into account the costs which society in general will be asked to bear anytime uninsured deposits are covered.

The Association of Reserve City Bankers (ARCB) agrees with the recommendation of Treasury not to assess insurance premiums on deposits at foreign branches of U.S. banks. It does support, as part of a general industry agreement, however, a special assessment to cover the cost of loans to recapitalize the Bank Insurance Fund that would be calculated on the basis of bank assets net of capital (calculating capital to include subordinated debt and loan loss reserves).

A workable system of risk-based insurance premiums is supported by ARCB as a potentially important tool in apportioning the costs of failures among insured depository institutions.

ARCB supports the recommendations which have been made by Treasury for dealing with the deposit insurance practices of credit unions. Additional changes need to be made in the future to eliminate disparities which exist between credit union and bank regulatory requirements.

BIF Recapitalization

ARCB supports efforts by the administration and the FDIC to recapitalize the Bank Insurance Fund. Such a recapitalization of the Fund should be coupled with plans for modernizing the banking system. Under no circumstances should those or other BIF funds be used to pay the extra costs involved when uninsured depositors receive full protection in a bank failure.

ARCB is in agreement with the banking industry plan calling for the Bank Insurance Fund to borrow up to $10 billion from private sources on an "as needed" basis through the issuance of bonds. These bonds would be amortized through a special annual assessment paid by BIF insured institutions. It is desirable that these funds be borrowed from private sources to avoid any appearance of a taxpayer bailout. The special assessment should apply to a broader base than the regular premium, with the broadened base to consist of an institution's assets net of capital (including loan loss reserves and subordinated debt). Under any recapitalization plan, the assessment rate on banks should be capped to continue to allow the industry to attract and retain capital. Under the industry plan, the regular assessment rate would be capped at 19.5 basis points and the regular assessment would continue to be calculated on the current basis.

ARCB believes the industry should receive full credit for sterile reserves held at Federal Reserve Banks under any condition but particularly in connection with a recapitalization of the Bank Insurance Fund. Payments into and out of the Fund should be taken off budget so that decisions about the federal deficit have no bearing on insurance assessment decisions.

Financial Modernization

ARCB believes the banking and financial system should be modernized to allow banking institutions to engage in a broader range of activities. It supports the Treasury recommendations to engage in securities, mutual funds and insurance activities.

Particular care should be taken not to place U.S. banking institutions at a competitive disadvantage relative to foreign institutions. This includes the types of activities in which U.S. institutions can engage and the structural form they can use to integrate new financial activities with current banking activities as a means of operating more efficiently in the future. The types of activities in which banking institutions can engage should continue to be reviewed and changed as financial markets change at home and abroad. Particular care should be taken to see that whatever financial structure the U.S. adopts is sufficiently flexible to allow U.S. institutions to compete against foreign institutions operating under a wide variety of different structures, including through banks directly, through subsidiaries of banks or through subsidiaries of holding companies.

Particular care should also be taken in avoiding adoption of U.S. policies which would invite retaliation against U.S. banks in foreign markets. ARCB does not support granting U.S. bank regulatory agencies authority to deny foreign banks access to U.S. banking markets on the basis of the treatment U.S. banks receive in the markets of that foreign bank's country.

In modernizing the U.S. financial framework, it would be advantageous to allow U.S. institutions to choose the framework that is most efficient and structurally sound.In addition, some activities should be allowed to be engaged in by banks directly. The opportunity to engage in new activities through subsidiaries of the bank, as opposed to separately capitalized subsidiaries of the holding company, should also not be foreclosed. A system is needed to ensure that the federal safety net does not extend beyond the insured depository to any subsidiaries or affiliates which are not subject to federal bank regulation. But, efforts to protect the insurance system and the safety net should not cancel out the benefits gained from expanded authority for new banking activities, and care must be taken to assure the efficiencies and benefits of allowing financial services providers to offer a wider variety of products and services are not undermined by the imposition of cumbersome new firewalls. It is not necessary or desirable to restrict cross-management or cross-marketing between banks and their affiliates or parents.

ARCB supports a liberalization of geographic barriers to nationwide banking. Treasury recommendations calling for nationwide banking for holding companies and interstate branching for banks are consistent with this position.

ARCB supports commercial companies owning banks or, as the Treasury recommends, owning financial services holding companies which can own banks. Care will need to be exercised not to extend the intensive regulatory framework which applies to banks to commercial entities or the financial services holding companies they own.

Banking Regulation

ARCB supports a streamlining of the bank regulatory structure. Important factors in any regulatory reorganization would be the effect any change would have on increasing the efficiency, maintaining the consistency and reducing the costs of future bank regulatory, supervisory and examination activities. The Bank Insurance Fund should not be merged with the Savings Association Insurance Fund.

ARCB supports efforts to improve the regulation, supervision and examination of banks in the future. ARCB supports prompt and effective action being taken by the bank regulatory agencies in dealing with troubled institutions. The regulatory agencies should engage in early intervention in undercapitalized banks, as measured on an objective and consistent basis, so that they can be dealt with before they become insolvent. The deposit insurance system or the bank regulatory framework should not be used to prop up insolvent banks. Particular care should be taken not to adopt regulatory requirements that would impede the acquisition of undercapitalized banks by institutions that are well-capitalized and capable of handling such acquisitions. The supervision and examination of banks should be applied on a consistent basis. ARCB supports legislation to clarify a bank's liability arising from environmental clean-up costs.

With respect to future safeguards for banking and affiliate activities, care should be taken not to restrict affiliate relationships or unnecessarily hinder the efficient functioning of banking and financial institutions. Sections 23A and 23B currently in place effectively insulate banks from their affiliates and restrict harmful loan and securities transactions between banks and their affiliates. ARCB does not support any restrictions on the activities of state-chartered institutions. Banks should not be required to shift all of their securities or other financial activities currently conducted in the bank to separate subsidiaries. Banks should be allowed to continue to underwrite asset-backed securities directly rather than through an affiliate.

ARCB is opposed to market value accounting of bank assets and liabilities. ARCB also opposes the inclusion of interest rate risk in the future calculations of capital under the risk-based capital standards. Unilateral action by the U.S. in either of these instances would be particularly inappropriate since this would place U.S. institutions at a competitive disadvantage relative to foreign institutions.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
ON H.R. 1505 AND H.R. 2094

June 6, 1991

The Investment Company Institute*/ respectfully submits this statement in connection with the Ways and Means Committee hearings on H.R. 1505 and H.R. 2094. H.R. 1505 is the Administration's proposal for reforming the deposit insurance system and restructuring the financial services industry. Specifically, the bill would modify the regulation of banks and other depository institutions and expand allowable activities of banking corporations. H.R. 2094 is a narrower bill limited to recapitalizing the bank insurance fund. The Institute's tax-related comments on these bills deal with only one aspect of the legislation: the tax treatment of bank common trust and collective investment funds in sections 245 and 246 of H.R. 1505.

Specifically, the Institute suggests that the tax law treatment of bank common trust and collective investment funds mirror the treatment of such funds under banking and securities law. Thus, to the extent that a bank common trust fund satisfies the requirements for exemption from the Investment Company Act of 1940 pursuant to section 3(c)(3) of that Act, as amended by section 245 of H.R. 1505, such fund should be deemed eligible for pass-through tax treatment under Code section 584. However, in the case of a common trust fund that is required to register under the Investment Company Act of 1940, such fund should be ineligible for taxation under section 584. Similarly, in the case of a bank collective investment fund required to register under the Investment Company Act of 1940, that fund should not be permitted to rely on Rev. Rul. 81-100, 1981-1 C.B. 326, to obtain conduit tax treatment.

H.R. 1505

Section 245 of H.R. 1505 describes the treatment of bank common trust funds under the federal banking and securities laws. Under this provision, a bank common trust fund may fall within the exclusion from coverage under the Investment Company Act of 1940 only if the common trust fund is used exclusively to assist the bank in the administration of its fiduciary accounts and not as an investment vehicle for the public. Thus, the provision sets forth three standards which must be met by a common trust fund claiming exclusion from the Investment Company Act. First, the common trust fund must be established solely for the purposes of administration of fiduciary accounts. Second, the fund must not be advertised. Third, the bank must not charge the fund fees and expenses that, when added to the fees and charges to participating trusts, would exceed the costs to the trust if its assets had not been invested in the fund. A bank common trust fund failing to meet these conditions would not fall within the section 3(c)(3) common trust fund exemption from registration under the Investment Company Act.

Section 246 of H.R. 1505 directs the Securities and Exchange Commission, in consultation with the Department of Labor, to study the appropriate treatment of bank collective investment funds and insurance company separate accounts that are organized for the investment of certain retirement plan assets, which are currently exempt for the Investment Company Act (as well as the treatment of bank common trust funds). The goal of this study, as set forth in the section-by-section analysis prepared by the Administration, is "to adopt a regulatory scheme that protects investors in pooled investment funds on a equal basis, regardless of whether the funds are pooled by investment companies, banks or insurance companies".

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*/ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 3,242 open-end investment companies ("mutual funds"), 209 closed-end investment companies and 12 sponsors of unit investment trusts. Its open-end investment company members have assets of about $1.15 trillion, accounting for approximately 95 percent of total industry assets, and have about 36 million shareholders.

Current Law Tax Treatment of Bank Common and Collective Funds

Under current tax law, a bank common trust fund may obtain conduit tax treatment under either Code section 584 or Subchapter M. Section 584 defines a common trust fund generally as a fund maintained by a bank exclusively for collective investment by the bank in its fiduciary capacity and in conformity with the prevailing rules and regulations established by the Federal Reserve Board and the Comptroller of the Currency. It apears that this provision was intended to grant conduit tax treatment to only those common trust funds established solely as an aid to the bank in the exercise of its bona fide fiduciary duties. At the same time that Congress enacted section 584 (then section 169 of the Revenue Act of 1936), Congress enacted a separate, detailed statutory scheme governing the circumstances under which securities pools offered to the public for investment (regulated investment companies) could obtain conduit tax treatment. The terms and conditions of this second statutory scheme (Subchapter M) were more detailed and rigorous than those contained in section 584. In light of the Congressional policy to restrict the availability of conduit tax treatment to carefully circumscribed instances, section 584 should be interpreted narrowly so as to encompass only the traditional common trust funds for which it was enacted, i.e., those used only as an administrative aid to the bank acting in its capacity as a bona fide fiduciary. An alternative regime, Subchapter M, exists for funds offered to the public for investment.

Bank collective investment funds established for the purpose of pooling the assets of certain retirement plans obtain tax-free status under Rev. Rul. 81-100. This ruling provides that a group trust which consists solely of the assets of tax-exempt pension trusts and individual retirement accounts may itself be tax-exempt.

Tax Treatment of Bank Common Trust Funds Under H.R. 1505

As noted above, section 245 of H.R. 1505 prescribes the specific circumstances in which a bank common trust fund can qualify for exemption from the Investment Company Act. These conditions should also be applied to section 584 of the Code. Thus, it should be made clear that a common trust fund seeking conduit tax treatment under section 584 must also satisfy the conditions set forth in section 245 of H.R. 1505 for exclusion from registration as an investment company. A common trust fund that fails to meet one or more of these conditions should be excluded from section 584. Since such a fund would not be one maintained solely by the bank as an administrative aid to its conduct of bona fide fiduciary duties, conduit tax treatment should be available only if it can satisfy an alternative tax regime, such as Subchapter M.

To clarify this, the Institute proposes an amendment to section 584(a)(2) to include within the definition of a common trust fund only a fund which is excluded from registration under the Investment Company Act pursuant to section 3(c)(3), as amended by section 245 of H.R. 1505.

A conforming amendment also should be made to section 851(a)(2) to include within the definition of a regulated investment company only those common trust funds which meet the section 584(a) definition of a "common trust fund". Pursuant to this amendment, a common trust fund meeting the standards for exemption from the Investment Company Act set forth in section 245 of H.R. 1505 would be permitted the option to obtain conduit tax treatment under either section 584 or Subchapter M. However, a common trust fund which does not qualify for the exemption from registration provided by section 245 of H.R. 1505 would be required to register as an investment company and could qualify for conduit treatment only under section 851(a)(1).

Tax Treatment of Bank Collective Funds Under H.R. 1505

As noted above, H.R. 1505 has directed a study regarding the appropriate securities law treatment of bank collective investment funds. If that study concludes that bank collective investment funds marketed to retirement plans must register under the Investment Company Act, we would urge the revocation of Rev. Rul. 81-100 as applied to bank collective investment funds. As in the case of bank common trust funds, a collective investment fund required to register under the Investment Company Act of 1940 should be free from an entity-level tax only if it complies with Subchapter M.

Conclusion

The Institute urges consideration of the suggested amendments to Code sections 584 and 851. We would be pleased to meet with the staff of the Committee and offer our assistance in clarifying the tax treatment for bank common trust and collective investment funds.

JIM MOODY
WISCONSIN

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Statement of Representative Jim Moody (D-WI)
Committee on Ways and Means
Recapitalization of the Bank Insurance Fund
May 29, 1991

In January, 1991 the Financial Institutions Subcommittee of the House Banking Committee released a study done by 3 independent economists that said, in essence, that the Bank Insurance Fund was broke. It said that historical accounting was camouflaging the true economic declines in bank capital and earnings.

In March of the same year, the non-partisan and highly respected Comptroller General Charles Bowsher said of the Administration's plan to allow the Bank Insurance Fund (BIF) to borrow from the Treasury:

> "I've been through taxpayer bailouts before and this is how they often get started."

In April, just a month later, the General Accounting Office (GAO) reported to Congress that the BIF was worth only half of what the FDIC claimed, $4-$5 billion instead of the $8.4 billion unaudited FDIC figures showed.

Now, Mr. Chairman, we are asked to bless a plan that would open the Treasury's doors to the tune of $30 billion for more bank bailouts.

Of course, the regulators and the industry are calling this a "loan." But if enough of the banking industry was solvent, the FDIC could recapitalize the insurance fund with higher premiums.

The fact is, this "loan" may never be paid back. Mr. Bowsher's warning stands loud and clear as a clarion call. We have been told that the emperor is naked; we cannot blithely continue to admire his beautiful clothes. We did that with the S&Ls and will be paying the price for decades to come. This is a taxpayer bailout, and before we put our stamp of approval on it, we must face that fact.

I am not arguing that we should not recapitalize the insurance fund. We must.

But if the taxpayers are going to be put on the hook, then it is time to stop having them subsidize bank shareholders.

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Why, Mr. Chairman, was capital-starved Citibank paying out the equivalent of 50% of its core capital in dividends as little as 10 months ago? Those dividends should have been used to shore up that bank's capital, which Federal Reserve Chairman Greenspan repeatedly tells us is the last line of defense between the taxpayers and the banks.

Why, Mr. Chairman, did the Federal Reserve wait until February to set a policy that prevented banks from depleting capital to pay dividends?

Undercapitalized banks must stop paying dividends. And, as the Banking Committee and GAO reports make abundantly clear, for these purposes at least, capital must be calculated on the basis of market, not historical, values. That is the only way to get a real and accurate picture of the economic health of banks.

I am preparing legislation, based on the greenmail tax developed by this Committee, that will place an excise tax on dividends paid by undercapitalized banks. Bank shareholders, not taxpayers, must bear the burden of managements' miscalculations.

My colleagues should be clear about the impact of this tax. It will not adversely affect well-run banks, such as those in my home state of Wisconsin.

I have been asking the Federal Reserve for information on dividend pay-outs, but have been unable to get the necessary information.

Lest I paint a picture with too broad a brush, Mr. Chairman, let me point out what often gets lost in this debate. The vast majority of banks in this nation are well capitalized and well run. Wisconsin banks, for example, have an average of 10% core capital, two-and-a-half times the minimum required level. They represent no threat to the insurance fund or the financial system. Yet they, and their traditional customers and investors, must bear the burden of higher insurance premiums because of the bad decisions and poor management of the few.

This is not fair, and we must address this inequity.

I hope that the witnesses before us today can help alleviate some of these concerns. I look forward to hearing their testimony.

STATEMENT OF

U.S. LEAGUE OF SAVINGS INSTITUTIONS

INTRODUCTION

The U.S. League of Savings Institutions* welcomes this opportunity to present its comments on tax rules currently applicable to banks, thrifts and other competing financial institutions within the context of the banking and insurance reform proposal of the Bush Administration.

As a threshold issue, we would like to comment on the continuing role of savings institutions in mortgage originations and portfolio investment. As this committee is well aware, a segment of irresponsible, and sometimes criminal operators, have wrought tremendous damage to the industry, and via federal deposit insurance backup, to innocent taxpayers. The excision of that cancer, together with the well-known general weakness of the real estate sector in the current recession, has produced a considerable retrenchment in the thrift business.

The healthy and substantial core of the thrift business, however, remains as the major ongoing source of mortgage credit. Problems with the outmoded structure of federal lending statistics tend to disguise that ongoing role. First, the origination activity of thrift (and commercial bank) institutions via mortgage banking subsidiaries either is not counted at all or is credited to the mortgage banking sector. In fact, the majority of the mortgage banking credits should be tracked up the corporate chain and allocated appropriately to thrifts, banks or other financial services or diversified holding companies. There is relatively little left of the autonomous mortgage banking sector though, as subsidiaries of other corporations, vital origination services are still performed by that business. The question is merely one of appropriate "look through" allocation.

Secondly, the role of the federal secondary market agencies should be clarified. Those agencies do not originate. Their major role is securitization, i.e., guarantee and packaging function for mortgage credits. Their direct ownership is increasingly only a warehousing function.

This role is certainly critical and one that is currently under Congressional and Administration scrutiny. The point here is only that when an institution securitizes its loans by merely adding the federal guarantee for a swap fee, the institution remains the originator and ultimate portfolio owner of the underlying credits. Though an increasing proportion of originations have a federal involvement with these agencies, often because of capital requirements on depository institutions both bank and thrift, those primary lenders remain always the customer contact and often the portfolio holder.

Thrift institutions, when accounted for properly, remain often the single largest and always a major force in the residential loan market and that role will continue as the shake-out of the remaining weak institutions in the depository sector is completed.

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* The U.S. League of Savings Institutions serves the more than 2,300 member institutions which make up the $1.05 trillion savings association and savings bank businesses. League members inlude all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Donald B. Shackelford, Chairman, Columbus, Ohio; Robert B. O'Brien, Vice Chairman, Morristown, New Jersey; Frederick L. Webber, President, Washington, D.C.; J. Denis O'Toole, Executive Vice President for Governmental Affairs. League headquarters are at 1709 New York Avenue, N.W., Suite 801, Washington, D.C. 20006. Telephone: (202) 637-8900. The Chicago office is located at 111 East Wacker Drive, Chicago, Illinois 60601. Telephone: (312) 644-3100.

The U.S. League as the major representative of those institutions would like to take this opportunity afforded by Chairman Rostenkowski and the Ways and Means Committee to address two tax issues of competitive importance to our thrift industry members:

- taxation of credit unions
- thrift reserve recapture

TAXATION OF CREDIT UNIONS

In 1909 the credit union movement was launched in this country with the passage of the Massachusetts Credit Union Act. From those laissez faire days in the early 1900s, credit unions have grown enormously in recent years with assets now totaling $195 billion and 62 million members served by 14,550 federally insured institutions. In 1970 credit unions received federal deposit insurance coverage for the first time. This important federal breakthrough alleviated member concerns for safety and soundness thereby allowing credit unions to escape their traditional 'common bond' restrictions. By its very nature, however, the grant of such insurance diminished the nature of credit unions as lending cooperatives for their members and brought them into more direct competition with other types of depositories. In 1977 Congress began modernizing credit union powers, authorizing mortgage loans in 1978 and transaction accounts in 1980. Today credit unions often offer the same broad range of financial services as their community thrift or local bank competitor--student loans, credit cards, consumer loans, commercial loans, real estate loans and home equity lines of credit.

In spite of this rapid expansion into services offered by their tax-paying financial competitors, credit unions continue to enjoy exemption from federal taxation. Without the burden of taxation, credit unions will always continue to enjoy a disparate competitive advantage of approximately 34 percent. In view of the industry's current size and strength, is blanket tax exemption for credit unions still appropriate? The thrift industry believes strongly that such an exemption cannot be justified by any measure of competitive equity. By way of comparison, in 1951 when thrift institutions were first subjected to federal taxation, our industry had $19.2 billion in assets at 5,955 federally insured savings and loans. Allowing for inflation, that 1951 asset figure is comparable to current credit union holdings. The time is right for credit unions to bear their fair share of federal tax as their thrift and banking competitors have been doing for decades.

When taxation of credit unions was previously suggested by the Treasury as part of the initiative leading to the 1986 Tax Reform Act, an asset limit was suggested to preserve the tax exemption for those credit unions that had preserved their status as a volunteer part-time credit cooperative. That concept has genuine merit as a method of distinguishing between those credit unions in full de facto competition with taxable service providers and those serving a credit niche removed from the general market. The variety of values suggested for the cut-off--$5 million, $10 million, $25 million--is less important than the establishment of tax parity between competitive equals. A $25 million cut-off would eliminate the vast majority of credit unions, though some thought would have to be given to charter and asset splitting in multi-credit union "holding companies." The tax exemption should be better targeted to the nature of the entity. That is our sole concern.

THRIFT RESERVE RECAPTURE

The U.S. League would also like to propose an important tax rule clarification unique to our business. This clarification would allow our member institutions to ease a prohibitive tax liability incurred when their loan loss reserves are required to be brought back into income. The question that needs to be answered is what are the tax rules governing thrift loan loss recapture?

Two actions currently trigger loan loss recapture for thrifts--changing to a bank charter and failing the 60 percent asset test outlined in IRC 7701(a)(19)(C). The third thrift action forcing recapture is specifically described in IRC Section 593(e). This section provides that when a thrift institution makes a distribution to its shareholders out of excess loan loss reserves (i.e., in general, the excess of the reserve for losses on qualifying real property loans over the reserves which would have been allowable under the experience method), it must report that amount as income.

Historically, thrifts, unlike publicly owned commercial banks, could not raise capital and increase reserves through the sale of stock, but as mutual institutions were forced to rely exclusively on the retention of earnings. In addition, thrifts needed larger reserves than banks because of their structural asset-liability mismatch---short-term liabilities funding long-term mortgage loans. Without these special Congressionally authorized reserve tax rules, the mutually owned thrift business would not have been able to increase either their capital or their mandated residential housing investment.

In recent years, we have seen increased efforts, both legislative and regulatory, to facilitate movements between the banking and thrift industries. The Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA) began this push toward unifying the financial industry with the so-called Sasser Amendment authorizing direct thrift-to-bank conversions. FIRREA also facilitates non-supervisory acquisitions of thrifts by bank holding companies.

The details of the FIRREA Qualified Thrift Lender (QTL) provision is still another indication of legislative intent to facilitate the switch of thrifts to banks. The legislation requires a thrift to maintain 70 percent of its assets in qualifying loans. If the institution does not, it will be restricted immediately to permissible investments and activities of a national bank which are also authorized for a savings association. Branching and dividend limitations are also imposed for failing the new FIRREA qualified thrift lender test. The institution is also given the option, when subject to these restrictions, of switching to an actual commercial bank charter.

The Bush Administration is also demonstrating a desire to merge the thrift and banking industries by recommending in H.R. 1505, their major banking and insurance reform legislation, a single regulator within Treasury for both types of financial institutions.

On November 12, 1990, the Office of Thrift Supervision (OTS) issued a legal opinion authorizing federally chartered thrift institutions to convert directly into commercial banks for the first time. In the past, such conversions had to be accomplished indirectly by having a thrift institution first convert into a state chartered thrift and then, under state law, into a state or national bank. This OTS action simplifies the conversion process and further demonstrates the willingness of federal regulators to assist merging of the banking and thrift institutions.

In this post-FIRREA financial marketplace where thrift-bank mergers are being encouraged and higher capital levels demanded by regulators, our tax laws should also facilitate these important FIRREA objectives. Unfortunately, the effort to realign the thrift and banking industries, according to market forces, continually encounters a prohibitive barrier--the tax treatment of thrift loan loss reserves.

The tax treatment of a nonqualified thrift's loan loss reserves prior to the Tax Reform Act of 1986 was unclear. The reason for this was that there were few thrift conversions and almost no thrift asset test failures. The passage of the Tax Reform Act of 1986 (the 1986 Tax Act) finally and authoritatively addressed the tax treatment of loan loss reserves explicitly for commercial banks and implicitly for thrifts. In that legislation, large banks (over $500 million in assets on a consolidated basis) were prohibited from using the experience reserve method and required to adopt the specific charge-off method of accounting. This new method allows large banks direct deductions against taxable income whenever losses are recognized, but never in advance. In order to prevent double deductions for large banks after the 1986 Tax Act, existing loan loss reserves for large banks were required to be recaptured. Special rules were provided for recapturing large bank loan loss reserves either over a four-year period (Sec. 585(c)(3)) by using the direct recapture inclusion method or by using the cut-off method (Sec. 585(c)(4)). Both of these recapture methods under Section 585(c) provide a more favorable income spread than what the Internal Revenue Service claims is appropriate for thrifts--six-year pro rata recapture.

Small banks (under $500 million in assets on a consolidated basis) are permitted to continue using the reserve accounting method (Sec. 585(b)(3)) which is the only reserve method still available to banks. Thrift institutions, like small banks, retained their experience reserve accounting treatment for loan losses (Sec. 593(b)(3)) as well as their incentive reserve (albeit at a much reduced level) for residential housing investment.

The U.S. League strongly believes that loan loss recapture rules should be no more severe for thrifts than their commercial bank competitors. A similar view on thrift reserve recapture equity with commercial banks is described in the General Explanation of the 1986 Tax Act ("The Blue Book") at page 556:

> An entity previously treated as a thrift institution that does not meet the new definition of thrift institution (under the 60 percent test) generally is treated as a commercial bank if it otherwise satisfies the definition of Section 581. An entity previously treated as a thrift institution now treated as a commercial bank is subject to the tax rules applicable to commercial banks [emphasis added]. If the adjusted bases of the assets of the entity (or any controlled group of which the entity is a member) exceed $500 million, such an entity would be considered a large bank and ineligible to use the reserve method of computing deductions for losses on bad debts. The existing bad debt reserve of such an entity is required to be recaptured using either the direct recapture inclusion method or the cut-off method.

This explicit language contained in the authoritative Blue Book description leaves little doubt that the Congressional Joint Tax Committee (authors of the Blue Book) believed in May of 1987 (date Blue Book published) that thrift reserve recapture would be covered by the same rules provided commercial banks. That intent is absolutely consistent with the literal language of the revised Revenue Code.

The fact of the matter is that a thrift is a specialized bank (Sec. 593). When and if it fails to be a qualified thrift (Sec. 7701(a)(19(C)), it becomes a bank (Sec. 581). The new bank entity forfeits all benefits of a Section 593 institution while at the same time becoming eligible for all rules applicable to banks under Sec. 585, including the bank recapture rules of Subsection (c).

In November 1989, the IRS caused great confusion within our industry when, in an informal letter sent to the Joint Committee on Taxation by Commissioner Goldberg, he stated that thrifts were not eligible for the bank recapture rules (Section 585(c) because of Revenue ruling 85-171, 1985-2, C.B. 148 issued one year before passage of the 1986 Tax Act. The Revenue ruling was based on a change of accounting theory and superceded the 1986 Tax Act by requiring thrifts to recapture reserves on a less favorable, six-year pro rata basis. The IRS continues to defend its position on thrift recapture by arguing that the bank recapture rules would provide a greater benefit to thrifts than banks because of their larger reserves. The larger thrift reserves, however, are not accidental. They result from Congress specifically providing thrifts with greater reserve inducements in return for their unprecedented commitment to residential housing investment. Consequently, the larger thrift reserve intentionally provided by Congress will, by its very nature, always be a bigger item under identical recapture rules. Why should thrifts be penalized because of their strong commitment to housing by denying them the 585(c) bank recapture rules? It would seem both more reasonable and consistent with the statute, to allow similar financial institutions to recapture their reserves under identical rules rather than focusing on irrelevant distinctions.

The U.S. League believes that the Blue Book description of the recapture rules for thrifts accurately reflects what, at the very least, Congress intended in 1986--that the fairer more equitable result requires that when thrifts, like banks, move to specific charge-off accounting for whatever reason, their loan loss reserve recapture treatment should follow the statutory commerical bank rules of Section 585(c). Thank you for allowing us this opportunity to present our comments on these important issues.